The ACCOUNTING REVIEW

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APPLICATION OF ACCOUNTING RULES AND STANDARDS TO FINANCIAL STATEMENTS

Howard C. Greer

Accounting principles have been under active discussion in recent months. All of you, no doubt, have read some of the material on this subject which has been appearing in the accounting publications. If you have followed that discussion, you probably have noticed that accountants cannot agree, even as to what a principle is.

The Executive Committee of the American Accounting Association, of which I was a member at one time, issued a little pamphlet several years ago, under the title, "A Tentative Statement of Accounting Principles." It received a good deal of criticism, principally to the effect that the Committee did not know a principle when it saw one. With due deference to the critics, I submit that this really is not the essential question.

What the Committee had in mind, I believe, is that published financial statements might be improved by more uniform application of certain rules or standards or principles or conventions, or whatever anyone wants to call them. This is a debatable question, and for that reason, perhaps, I have been invited to discuss it with you this morning.

Possibly some of you have read the paper which I presented last fall at an accounting conference at the University of Michigan on the subject, "What Are Accepted Accounting Principles?" The remarks I made at that time led several members of the accounting profession to write to me in disagreement and protest. The ideas expressed in some of these letters are interesting and significant, and it occurred to me that this audience might be interested in them and in what I have been able to develop by way of reply and further investigation of the problem.

What I am taking particularly for my text here this morning is a comment appearing in one letter I received, which I should like to read to you. This is from the senior partner of one of the large accounting firms. He wrote to me after this conference at Michigan and said (among other things):

> It seems so clear to me that there can be no fundamental and inexorable principle for determining what amount is to be credited in the income account of a single year in respect to profits which are admittedly the result of operations and transactions extending over a period of several years that I am at a loss to understand why the search for such principles continues.

I responded that I thought the profession had perhaps been a little less aggressive than it might have been in bringing before business men the necessity for a more nearly uniform approach to the problem of presenting intelligible financial statements. He replied to my letter with this further comment:

> I regard the proposition that greater uniformity than the standard roughly outlined in Mr. George May's lectures at Harvard University

necessarily implies improvement as an unproved hypothesis. I think inadequate consideration has been given to these questions: What advantages would result from a more nearly complete uniformity? Who would benefit? What disadvantages would result? Who would suffer? A consideration of these questions might result in a case for greater uniformity, but that is, by no means, I think, a foregone conclusion.

I find that advocates of greater uniformity ignore practically all of these considerations I have mentioned and simplify their problem by assuming that uniformity is desirable and the only problem is how best to attain it.

That is a challenging statement, and worthy of serious discussion. Many of us have assumed that greater uniformity in accounting statements would be desirable. Perhaps we have been assuming too much. I can hardly claim to be a neutral, but it may serve some useful purpose if I endeavor to bring out some of the arguments on both sides of the question.

It is rather typical of the American spirit, particularly as reflected in the views of an audience like this, to feel that anything that cramps or restricts the activities of a professional group is undesirable. Many of you doubtless feel that what we need is free play for the absolutely unhampered judgment and conscience of the individuals who make up the group. This conviction is so strong in some accountants that they believe no one can have a different view unless he is actuated by personal or selfish motives. One commentator even suggested that the reason why people connected with the teaching profession were interested in greater uniformity in financial statements was that it would make accounting easier to teach. If such a notion as that prevails it is surely our duty to correct it.

What are the arguments for greater uniformity in the presentation of financial statements? Perhaps we should consider, first, whether some advance along this line is theoretically desirable, and second, whether it is practically necessary and important. The question might be decided as an academic proposition, but that is hardly worthwhile unless we look into the field of accounting practice to see what is actually happening at the present time and to determine whether the problem is significant enough to justify the attention that we have been giving it.

Is it theoretically desirable that there be greater uniformity in the presentation of financial statements? It seems to me that arguments for uniformity must be based on one of two grounds. It might be argued, for example, that there should be uniformity if there is some one best way of doing things, some way which is so superior to all other possible methods that it should be universally adopted. I doubt whether there is any single best way of presenting financial statements which is so much superior to all other ways that we can argue that it must be adopted. There are exceptions as to individual elements of the statements—points on which opinion has crystallized to such an extent that there is little excuse for divergences. For example, it is the commonly accepted practice throughout the accounting profession to state a depreciation reserve as a deduction from the assets against which it has been set up. Once in a while, you see a financial statement in which the depreciation reserve is set up in some other form, but I believe it could be agreed that a uniform procedure is most desirable.

There are other illustrations of the same sort of thing. For example, it is now quite generally accepted that adequate detail in financial statements is desirable. The accounting profession has gone a tremendous distance in imposing on itself and on its clients the responsibility for full disclosure of all the important facts in accounting statements. The situation now, as compared to what it was twenty years ago, represents, in my opinion, a tremendous advance.

Significantly enough, some of the greatest improvements in the matter of adequate disclosure and detail have occurred in the statements of those corporations which are not subject to any regulatory authority. These corporations, from their own knowledge of good practice, with the constant urging and cooperation of the independent and conscientious public accounting practitioner, have developed adequate detail in their statements in a manner that would have been undreamed of twenty years ago. Later, I want to quote one or two illustrations of the opposite tendency in places where you might perhaps least expect it.

Now, as to the question of practical necessity. If there is no one best way of presenting all published financial statements, is there any other consideration which argues for uniformity?

I think the other possible argument for uniformity is that there may be a broad, common interest in the subject matter of these statements which is so important and so impressive that we must yield a degree of our independence and our personal preferences in order to see that it is adequately taken care of. It is important that we maintain the right perspective on this problem, and it is to this subject that I should particularly like to address my remarks. The nature of the case is brought out somewhat further by this exchange of correspondence which I mentioned, and, in order to bring out the contrasting points of view on the subject, I shall read a quotation from a letter which I received and from my reply to that letter.

Here is what a prominent practitioner says (in part) about whether financial statements would be improved by greater uniformity:

> My own approach to the question is that, subject to any demonstrated public interest and the rights of creditors, the interest of the stockholders should control in determining the basis of accounting. Undoubtedly, when corporations seek a public market for their stock, they assume an obligation to potential investors in the stock that must be respected.
>
> I can quite see that a stock exchange, or the Securities Commission, might feel warranted in making listing or registration conditional on the acceptance of certain rules which it might deem to be in the interests of traders in the stock, even if those rules were not in the best interests of the stockholders who were not traders. However, large as is the proportion of business done by listed companies, I do not think the interests of speculators therein should be allowed to dominate the accounting of all corporations, whether listed or not. After all, there are, I think, only between two and three thousand companies whose securities are listed on any exchange. By far, the greater part of the stock of even these companies is held by investors to whom fluctuations in market value are not a major importance.
>
> In general, I think we should encourage people to look for profit from enterprise rather than from speculation. In my mind, the great defect of our Securities and Exchange law is the emphasis placed, both in the law and in the administration, on the interests of the in and outer.

Now, there is the point of view of a practicing public accountant who has had wide experience, and for whose opinion I have the greatest respect. But it is so far removed from the point of view which has been actuating some of us who have been interested in this subject that it seemed to me to call for a fairly extended reply. To bring out this contrasting point of view, I replied to this letter as follows:

> Probably, we lay a somewhat differing stress on what you term the public interest in financial statements. It seems to be quite generally accepted today that in a complex industrial and commercial society such as ours the progress and position of our great corporations is a matter of public concern. The profits of business enterprises the volume of business done by them, the way in which they invest their capital and distribute their income, all have an important bearing on public welfare generally. As long as it remains impossible to define profits, or to say with finality what shall constitute a proper measure of contributed capital as distinguished from undistributed profits, the facts of the situation are left in a fog of uncertainty which contributes nothing to a

satisfactory solution of problems of taxation, wages, investment, social security, employment, etc.

This may seem to you to be carrying the argument very far afield. I note that you distinguish even between the legitimate interests of various types of stockholders, and imply that information helpful to one might be harmful to another. Personally, I doubt whether the preference of the management and some controlling group of stockholders can be depended upon as the best guide as to how the profits or the capital of an organization should be stated, even in the interests of the "permanent stockholders," but that is not the entire point.

I believe that the public is coming to regard business enterprise essentially as a medium for serving public needs in matters of employment, capital investment, and the production of goods and services, and that business generally must accept a measure of public responsibility which it was never thought to have in past years. I am not discussing the rightness or wrongness of the public point of view, but merely its existence. Perhaps, this applies only to the larger enterprises, and perhaps my insistence on uniform application of accounting principles to corporate reports could be similarly limited. Perhaps, we could distinguish in some way as between those companies "affected with a public interest" and those of such limited scope that their affairs are of no public concern.

It has been my view that the legitimate needs and interests of the public at large can be satisfied by business itself, if business men will assume voluntarily the obligations which a large proportion of the public feels that they should assume. Among these—perhaps somewhat incidental—may be included the obligation of adequate disclosure of the nature and results of their operations, expressed in financial terms. Business has an instrument ready to its hand in the fine group of independent practitioners of accounting, who may be relied upon to present a fair and impartial view of these matters. I should like to see this instrument so used. I should like to see the public accounting profession work towards a situation in which (as I have said before) their findings may be in accord with some single set of principles which is sufficiently uniform and definite so that the statements based on them may have a commonly accepted meaning and significance to all persons interested.

Now, that may seem to you a very extreme point of view. It doubtless goes beyond the point of view which most business men, most accountants, at present are ready to take.

I may be entirely mistaken in my notion of the trend of public thinking in this important field. It may be that we shall see, in the course of a few years, a swing of the pendulum away from the present attitude of making everything the public's business, and that we shall go back again to the conditions which prevailed ten or fifteen or twenty years ago, when business affairs were considered the problem of the business man himself, and not the concern of anyone else. I doubt it, although that is merely a personal point of view and certainly not shared by everyone.

My feeling is that we are moving very definitely in a direction which all of us should be able to recognize, and that our most important task, as accountants and business men, is to adjust ourselves to the current of public thinking, and the direction of its flow, so that we may be able to keep afloat on that stream, if I may continue the metaphor, and not be dashed on the rocks of regimentation as a result of our unwillingness to face the facts.

Here is what my correspondent said in part, in reply to my letter:

> You say you regard the progress and position of our great corporations as a matter of public concern. It seems to me that the number of what can be called "our great corporations" which are not already subject to accounting regulation is a trivial fraction of the total number of corporations with whose accounts accountants have to deal. More important, however, I do not think that a superficial uniformity adds to the real knowledge of the public of the affairs of such corporations. If anyone is under the delusion that the accounts of all the railroads are fairly comparable he will inevitably reach unsound conclusions on such a premise.

And then again, a little later, he said:

> I should like to make it clear that I do not regard present corporate financial statements as perfect, nor do I deny that there are still certain points in accounting on which general agreement

might well be reached. I do not, however, think that the need for careful analysis by the average person would be obviated if uniform accounting methods were set up—indeed, I think the probability is quite otherwise. To my mind, there is, in our country, too much faith placed in rules as laying out a royal road to the desired goal, and too general a belief, born of the wish, that the complexities of life and business can be made simple by such rules.

You will note my correspondent's view that uniformity does not in itself produce simplicity or understandability, and that there are many corporations examined by accountants which involve no public interest. Apparently, he feels that these facts justify a position on the part of public accountants that they should not be too insistent on greater uniformity in the presentation of financial statements.

I was particularly interested in his reference to those classes of corporations which have been brought under some public regulation, and which have had uniformity thrust upon them from the outside. He mentions the railroad companies. Most of us, perhaps, do not pay a great deal of attention to the details of the financial statements of the railroads. Many of them are not audited by public accountants. We rely on statistics that are put out by the Interstate Commerce Commission or by the American Association of Railroads or something of that sort.

The accountant who wrote to me says that the accounts of the railroads are not comparable. It is noteworthy, however, that one thing about which there is almost no argument at the present time in discussions of the railroad situation is what the profits of the concerns actually are. They are stated regularly in the public prints, and there is no effective challenge of the correctness of the figures. At least, this regulation of their accounts has produced a set of figures on which everyone can reasonably well agree, and discussions as to what ought to be done about the railroads can start from that point.

Another group of enterprises in the same category are the public utilities, and pretty much the same sort of thing applies there. It does not apply so well, however, in the case of two other important groups of enterprises which are in the same category; namely, the banks and the insurance companies.

The situation, with regard to the banks, is particularly interesting. The banks have been subject, in the last few years, to a greatly increased amount of regulation and supervision. One of the things that regulation certainly has not done, up to the present time, is to improve the published financial statements of banking institutions. What has occurred in their case is likely to occur in other cases. The regulatory authorities, with the entire banking system under their supervision, apparently have concluded that the right thing to do, in the interests of the public and everyone else concerned, is to supervise closely the operations of the banks, but without giving any great amount of attention to publishing adequate information on their results. In any such situation, when the regulatory authorities take full charge of affairs, they are likely to feel that their own judgment of the conditions is superior to that of the public at large, and that, therefore, it is not necessary for the public at large to have all the information it might want about the operations of the organizations under their control.

It would be unfortunate, in my opinion, if commercial and industrial enterprises of this country were placed in the hands of a supervisory or regulatory authority which would become so certain of its own ability to manage the affairs of those enterprises properly that it would feel it could dispense with adequate public information on the results of operations. I believe that one of our greatest safeguards in the preservation of a democratic form of government

and the continuance of a capitalistic system is a full and complete understanding on the part of the public at large as to what is actually going on, and for my part I do not want to have the facts strained through a sieve provided by any kind of a constituted regulatory authority.

The people who should audit and report on the affairs of corporations are the independent practicing public accountants of this country. There is no finer, abler, or more competent group of people, and if business is going to continue to do what it should do, and to satisfy the needs of this country, that is the kind of auditing and reporting on affairs of business that we need and want. My hope is that it will be possible for that group of men to work out over the period of the next ten, twenty, fifty years, if you please, the type of reporting and analytical procedure which will fully satisfy any public demands that may be made on them.

Now, does this all seem to you like something of a tempest in a teapot? In other words, am I making too much of the public interest in this matter? Let me remind you of some of the statements that have been made from high places in recent months, which convey definitely this point of view. If they accurately reflect public opinion, they leave us no option except to assume that business affairs are going to be a matter of continuing public concern.

All of you have heard it stated frequently that monopolies and combinations in restraint of trade maintain artificially high prices and earn unreasonably large profits. How is a question of that kind to be answered except by a clear, complete, adequate statement of what is earned by corporations in this country? You heard it stated from a very high source about a year ago that the price of copper had gone too high and that it ought to come down. You have heard it stated, from time to time, that the price of coal was too low and that something ought to be done to raise it. You have heard it stated that the price of steel was advanced last year by an amount that was unreasonable in the light of the wage advances that had been made in the steel industry. You heard it stated, less than a week ago, that the margins of bakers are now unreasonably high—that prices have advanced more than the costs and that the spread between the prices of the raw materials and the finished products is greater than for many years, etc.

If we are to meet that sort of thing constantly and repeatedly, it seems to me that we must arm ourselves with information on profits which is complete, adequate, well understood, generally accepted, and incontrovertible, so that we may be able to deal with claims of that kind when they are made.

Many people in government circles and elsewhere do not have confidence in the authoritative character of published financial statements, even though they are audited and certified to by public accountants. I should like to read, as illustrating that point, a brief quotation from a little publication called *The Agricultural Situation*, a monthly leaflet of sixteen or twenty pages published by the United States Department of Agriculture. The quotation is from an article in the April, 1938, issue, under the heading, "Earnings of Food and Tobacco Corporations," which contained a summary of the rate of return on investment in a number of companies in each of the several food fields, including the tobacco companies.

Here is a part of the comment which accompanied that tabulation:

> As the term is used here, earnings represent the amount of money available for stock dividends, interest on borrowed capital, and federal income taxes. They do not include the item of salaries to officers, which are usually reported by corporations as part of their operating expenses. It should also be pointed out that because of differences in accounting practice, as well as in the methods

used by the corporations in evaluating their assets, the earnings data given here can not be used to indicate that profits in any given food industry are either reasonable or unreasonable as of a given time.

In other words, this writer says that, if you want to know what has been going on in these industries you can not safely rely on their own published financial statements, even though they may have been audited by certified public accountants.

One more paragraph from this article:

The probability of a corporate enterprise is measured by its rate of return on invested capital. It is not possible to ascertain from the financial statements of most corporations exactly what this investment is. The closest approximation that can be made from the regularly published corporate statements is total capitalization, as represented by the sum of the outstanding stock, surplus, surplus reserves, and long term debt, but in using this measure, it should be kept in mind that the capitalization of a corporation will be affected by the book value which it puts upon its assets from time to time.

There, if you please, is a layman's point of view on the nature and content of published financial statements. Despite the obvious misconceptions which it embodies it is a point of view not to be disregarded, because it gives rise constantly to demands for greater regulation, for greater supervision, for more rigid application of accounting rules and standards in the operation of those enterprises. It is important, I submit, in considering whether great uniformity in published financial statements is important as a concession to an important and growing public demand.

But are the actual differences in published financial statements, as they now appear, significant enough to warrant our working seriously at this problem of trying to eliminate them—of developing a more satisfactory common denominator of presentation and disclosure and interpretation? Ever since this discussion of accounting principles and their application became most active, I have been urging that studies of actual published financial statements be made, to determine whether large and important differences in the treatment of identical items did actually occur in corporation statements. I believe this represents a very fruitful source of inquiry and will have an important bearing on this point.

One of the first of such studies appears in a talk given by Professor Hosmer of Harvard University, before the American Accounting Association Convention at Atlantic City last December. It is published in the March issue of the ACCOUNTING REVIEW. In that paper, which is very ably developed, Professor Hosmer has analyzed a number of published financial statements of large corporations. He devotes particular attention to the affairs of the United States Steel Corporation, one of the largest in the country, of course, and one on which very complete information has been published for a great many years.

The Steel Corporation, two or three years ago, set up out of surplus a special reserve, amounting to some $270,000,000, to provide for obsolescence and depreciation of its fixed properties which had not been recognized in the accounts in prior years. Professor Hosmer points out that if this additional obsolescence had been treated as a charge against earnings over a period of years, it would have reduced them by a very substantial sum. But, he says, and no doubt with a great deal of validity, that it probably was impossible during those earlier years to anticipate the full extent of that obsolescence, and, therefore, the corporation and its accountants are in no way to be criticized for not having made adequate allowance for these factors at the time.

I concur in this opinion, but not in some of the conclusions which the author draws with regard to the final disposition of this $270,000,000 charge. Here is part of his comment:

> The amount of $270,000,000 (previously explained) might have been included in the income statement for 1935 in a section following the operating section, and listed therein as a charge "applicable to, but not recognized in, prior years." Such inclusion would have resulted in showing an enormous net loss for the year, amounting to $30.89 per share of common stock outstanding. If this figure had been accepted by the community as figures of income and loss are usually accepted, it would have had an unfortunate effect on public confidence when the country was recovering from a severe depression.

That seems to me a remarkable point of view towards the considerations which should actuate accountants in the preparation of published financial statements. I must admit that it is one entirely new to me, but I leave it to you without further comment, as a statement of one possible point of view on this subject.

Professor Hosmer goes on a little further in the article to say:

> A second method under the principles suggested would have been to recast the income statements for the years affected, and include them in the annual report for 1935. The number of years for which the income statements would be revised would depend on the years over which the extra obsolescence was assumed to have occurred. It was, at least, ten, and it may have been thirty, years.
>
> The effects of the income statements of this corporation during preceding years had already been woven into the fabric of our economic life. Merely recasting these statements in 1935 would not have altered those effects and would not have made possible any changes in managerial decisions made in the past on the basis of income actually reported. It is difficult to see how either of these methods has any advantge over the policy followed by the Steel Corporation (which was, as I have stated, to charge the $270,000,000 directly to surplus).

The author concludes:

> In terms of the effects on stockholders and the general public, in view of the conditions in 1935, a charge through income would have accomplished nothing constructive and would have been positively harmful. The action taken was at that time the soundest alternative available.

In general the author's view is that the disposition of an exceptional or unusual charge of this kind is a matter of accounting policy, a matter of discretion with the corporation, and that so long as the discretion is honestly and soundly exercised, no rigid formula for disposing of this type of charge should be prescribed.

Now, that is a point of view. No doubt, it is very widely shared. Perhaps, the majority of you here today feel exactly as Professor Hosmer feels about it.

I do not. That is a personal point of view, also. I have a very strong conviction that a definite rule on the subject would be much more wholesome, and would be much more likely to produce intelligible financial statements over a period of years. If the directors of corporations were constantly aware that the values assigned to any assets on their books sooner or later would have to be amortized by charges to the income account, as the usefulness of the assets was lost, it would lead, inevitably, to a sounder and more conservative treatment of such assets from year to year, and eventually to more consistent presentation of financial affairs. It is a debatable point, but one that is worthy of very serious consideration.

Any extensive study of corporation financial statements will disclose the fact that there are widely divergent and unnecessary differences in practices in treating identical items. It is to these divergences and differences that I believe the public accounting profession in this country may well direct its attention in future years. A good deal already has been done. The work of the American Institute of Accountants, in collaboration with the New York Stock Exchange, has been very constructive. I hope it will continue, because there is a good deal still to be done along that line.

In the talk which I gave at Ann Arbor last fall, I commented briefly on the fact

that if the so-called "generally accepted accounting principles" are so loose in their application as to permit all of the things which have been done in financial statements presented over the certification of independent practicing public accountants, then they lead to no very accurate measure of the profits of corporations. And I stated that a group of corporations which I had been examining over a period of years has issued financial statements from which total profits may be computed at sums varying in the aggregate by over $100,000,000. The variance in the total would not be the result of differences in the measurement of the *amounts* involved, but of differences in the *classification* of items which accounts apparently consider debatable.

That was rather shocking to one of my friends in the profession, who wrote me a letter and said, "I find it hard to understand how there could be so great a variation as you mention. I think you would do a service if you would present a detailed analysis of those statements, and call attention to the points on which these differences occur."

Adopting this suggestion, I have taken the published financial statements of 18 corporations, over a period of nine years, and have analyzed all of the charges and credits to the surplus accounts, and all of the corresponding items which appeared on some occasions in the profit and loss statements. I have set up the profits of those corporations, first as they were stated by the companies and approved by their accountants, then as they would have been on each of two different bases—one, the most conservative possible treatment of all doubtful items, uniformly applied; the other, the most liberal possible treatment of all the doubtful items, uniformly applied.

The results are shown in the tabulation which is in your hands. You will observe that the most restrictive treatment would have resulted in an aggregate profit for those corporations over this period of years amounting to 98,000,000; the most liberal treatment would have resulted in an aggregate stated profit of $218,000,000. In other words, the profit of these corporations, under the uniform application of the procedure followed by some companies at some time, produces alternative profit showings which differ in a ratio of more than two to one.

The tabulation summarizes the items making up the aggregate potential difference in results. Certain things are omitted altogether from this summary. The list includes no differences related solely to the *amount* of a charge or credit—such as, for example, differences of opinion as to value that should be placed on an inventory, or the amount that should be written off for depreciation. The items listed are those having to do with the *disposition* of the charges and the credits, after the amounts have been determined. There are no items as to which all the companies (and their accountants) were of one opinion throughout the period; the list includes only items as to which the treatment differed at some time. Also, the list omits items which had to do with the adjustment of interests in subsidiaries—revaluation of the stock of subsidiaries, etc. Thus, the summary includes only questions arising in the affairs of an individual corporation.

The profits as shown by the published statements, aggregate $185,227,000. That sum appears at the top of both columns of the table. The column on the left is adjustment to a maximum profit showing, and the one on the right, to a minimum profit showing. Like items appear in the two columns.

The first sections contain, on the one hand, profit and loss debits which could have been made to surplus, and, on the

other hand, surplus debits which could have been made to profit and loss—could have been made, that is, if all of the accountants had followed in all cases the practice which some of the accountants thought was all right in some cases.

Group 1: *Extraordinary depreciation and losses on the sale or retirement of capital assets*—a very common item. There were six identifiable instances in which such charges were made directly to profit and loss. Doubtless, there were many more not separately mentioned in the published reports, but there were six that could be identified. They totaled $722,000. At the same time, there were 13 similar items charged to surplus. These aggregated $57,281,000. In other words, there were 19 instances of such importance that the auditors thought they ought to receive mention; six cases were decided one way and 13 the other way.

Group 2: *Intangible assets written off.* There were three cases in which charges were made to profit and loss, aggregating a little over a million dollars, and three cases in which the charges went to surplus, aggregating about $90,000. Six cases altogether with the accountants voting three to three on that point.

Group 3: *Adjustment of unamortized bond discount in connection with refinancing*—an item which was very common two or three years ago. In one instance $1,963,000 were charged to profit and loss, and in six other instances $8,769,000 were charged off to surplus.

Group 4: *Premium on own securities repurchased and retired.* None was charged to profit and loss, but there were four instances where such items were charged to surplus, aggregating $484,000. Discounts on such purchases were credited both to profit and loss, as noted later.

Group 5: *Special provision for pension fund.* There are no items shown under the profit and loss heading, but that is not a correct statement of the facts, because, undoubtedly, there were numerous provisions for pension funds made out of profit and loss; they simply did not show up as individual items on the statements and could not be readily identified. There was one provision of $1,000,000 for a pension fund which was made out of surplus, as shown.

Group 6: *Losses on foreign exchange.* There was one item that showed up as a charge to profit and loss and there probably were a good many more that did not appear. There were none charged to surplus, but there were handlings of the items which approximated the same thing—that is, there were differences in the treatment which justified including this item in the list.

Group 7: *Sundry charges of unusual character, or applicable to prior years, etc.* A group of miscellaneous adjustments of various kinds. Seven such items, amounting to $468,000, were charged to profit and loss, and 20 of them, totaling $3,325,000, were charged to surplus.

This makes seven different classes of items. Actually, the list is much longer than that, because Group 7 here includes quite a number of miscellaneous items. All of these are items as to which the procedure of the accountants differ, although, from the face of the statement, there was no way of telling that there was any actual difference in the nature of the items in the several cases.

If the profits were stated without deducting those debits to profit and loss (as shown in the left-hand column)—that is, if all of these amounts had been charged to surplus—it would have increased the profit by about $4,500,000. On the other hand, if all of the surplus debits had been treated as proper charges to profit and loss, it would have reduced the stated profit by $70,850,000.

The lower section of the summary con-

tains surplus credit which could have been made to profit and loss, and the profit and loss credits which could have been made to surplus.

Group 8: *Profit on sale of capital assets, etc.;* three instances in which credits were made to surplus, and three instances where they were made to profit and loss.

Group 9: *Gain on own securities repurchased at a discount and returned;* 32 items of that kind credited to surplus and 18 items credited to profit and loss.

Group 10: *Gain from cancellation of unpaid expense items previously charged against income* (that is, liabilities which had been set up and then were found not actually to exist and, therefore, were charged off); 11 cases where they were credited to surplus, and five where they were credited to profit and loss.

Group 11: *Adjustment of unamortized bond discount in connection with refinancing;* one of these turned up as a credit (most of them were debits)—this one credit was made to surplus.

Group 12: *Dividends received on own stock held in the treasury;* one instance of that, and only one, I'm glad to note. Since the correspondence about ten years ago between the American Institute and the New York Stock Exchange, that item has been almost completely eliminated from financial statements.

Group 13: *Sundry credits of an unusual character, etc.* (This corresponds with Group 7 above); twelve cases where the items were credited to surplus and four where they went to profit and loss.

A total of 59 credits appears in one column and 31 in the other. Altogether, there are 155 different items which appeared in these statements which were treated in some instances as profit and loss charges or credits, and in some instances as surplus charges or credits.

If all the accountants had taken the most liberal point of view which any of them took at any time, the aggregate profits of those corporations could have been stated as $218,000,000. If all of the accountants had taken the most conservative point of view which any of them took at any time, then the aggregate profits would have been no more than $98,000,000.

As to the results of the 18 companies stated individually, there would have been even more significant changes. In 10, the total profit would have been increased; in five cases, a decrease would have occurred; in three cases, there would have been no important change. If all of the charges and credits to surplus had been carried to profit and loss, the result would have been, in one instance, a change in the aggregate profit for a period into a loss; two cases of a change from a loss into a profit; and various changes in profits, increasing or decreasing, the largest, an increase in profit of 45 per cent.

This material is presented, not by way of criticism of anything that has been done by any company or any public accountant in connection with these financial statements. It is introduced merely as an illustration of what can occur if accountants permit a lot of these miscellaneous debatable items to go one way or the other according to the preference of the accountant or the management at some particular point of time.

I believe the summary does bring out, in a rather striking way, the necessity for extending and continuing our work of trying to bring about a more nearly uniform and common point of view with regard to these doubtful items. Every one of the items in this summary might well be the subject of consideration by the American Institute of Accountants and the New York Stock Exchange; by associations of public accountants which will study and consider this problem; by committees appointed particularly for this purpose.

The Executive Committee of the American Accounting Association has presented a tentative statement of principles, which deals with these questionable points. Everything that appears in this list could be definitely disposed of by every accountant if those principles, or rules, or standards, or conventions, or whatever you want to call them, were universally observed.

But, if the universal observance of those particular rules and conventions and standards is not most desirable, then it behooves the accounting profession and those who are teachers and research workers in this field to decide what rules should apply. If qualifications and exceptions are necessary in connection with them, then the problem is to state them. It is a difficult, complicated task, but it is not impossible. Only our diffidence, our preoccupation with other matters, a certain degree of inertia in tackling these things, prevents our getting this job done in some satisfactory fashion.

Any statement that a given suggested rule or principle is too rigid is an admirably constructive statement if it is accompanied by a suggestion as to what the proper qualification ought to be. It does not dispose of the question merely to say that the suggested rule is too rigid; that it can not be uniformly applied; that it would lead to injustices in a good many cases. Accountants must follow through and decide what qualifications are necessary; what alternative rule is applicable; what type of explanation is requisite.

If it is absolutely impossible to arrive at any kind of a uniform treatment of certain items—if their treatment necessarily varies so much between companies that the accountant must be left free play to do exactly as he pleases in handling them—then we ought to say so frankly and fully, and make it clear to everyone that within those particular limits our measuring device does not operate with any degree of precision. But, I think it will be found, if we study these problems in a sober and constructive way, that the number of such cases will be relatively small, and that a detailed statement of accounting principles can be developed which eventually can be turned to by practicing accountants with the assurance that there is some fundamental principle, or rule, or convention, which can be applied, with suitable exceptions and qualifications, in almost every instance.

Many people will not welcome that sort of a situation. Many people in business—many people in accounting work—would much prefer the maximum of freedom for the expression of individual judgment and opinion. I may be entirely wrong in supposing that the time for that has passed, and that the current of public thought today is in the direction of compelling us to do those things whether we want to do them or not. I leave that question entirely with you. But, I cannot forbear, in closing, to quote a statment that bears on this point.

This quotation is from Commissioner Healy of the Securities and Exchange Commission, and is taken from his talk before the American Accounting Association last December. Speaking of what he considered sharp practices by certain lawyers in invoking legal technicalities to defeat reasonable regulation, he said: "Practices such as these menace the welfare of capitalism. Those responsible for them should take heed, lest in winning too many such battles they lose the war."

We don't want to lose the war!

COMPARISON OF TOTAL PROFITS OF EIGHTEEN CORPORATIONS FOR NINE YEARS AS CALCULABLE ALTERNATIVELY ON MOST LIBERAL AND MOST CONSERVATIVE BASIS

(data in thousands—000 omitted)

Adjusted to Maximum Profit Showing

Profits as stated	$185,227
PROFIT AND LOSS DEBITS WHICH HAVE BEEN MADE TO SURPLUS:	
(1) Extraordinary depreciation and losses on sale or retirement of capital assets (6)	$ 722
(2) Intangibles written off (3)	1,053
(3) Adjustment of unamortized bond discount in connection with refinancing (1)	1,963
(4) Premium on own securities repurchased and retired	....
(5) Special provision for pension fund	....
(6) Losses on foreign exchange (1)	273
(7) Sundry charges of unusual character, or applicable to prior years, etc. (7)	468
Total debits (18)	$ 4,479
Profits without deduction of above debits	$189,706
SURPLUS CREDITS WHICH COULD HAVE BEEN MADE TO PROFIT AND LOSS:	
(8) Profit on sale of capital assets and reductions in stated depreciation of prior years (3)	$ 132
(9) Gain on own securities repurchased at a discount and retired (32)*	15,901
(10) Gain from cancellation of unpaid expense items previously charged against income (11)	10,992
(11) Adjustment of unamortized bond discount in connection with refinancing (1)	156
(12) Dividends received on own stock held in treasury	......
(13) Sundry credits of unusual character, or applicable to prior years, etc. (12)	1,166
Total credits (59)	$ 28,347
Profits with addition for above credits	$218,053

Adjusted to Minimum Profit Showing

Profits as stated	$185,227
SURPLUS DEBITS WHICH COULD HAVE BEEN MADE TO PROFIT AND LOSS:	
Extraordinary depreciation and losses on sale or retirement of capital assets (13)	$ 57,281
Intangibles written off (3)	90
Adjustment of unamortized bond discount in connection with refinancing (6)	8,769
Premium on own securities repurchased and retired (4)	384
Special provision for pension fund (1)	1,000
Losses on foreign exchange	......
Sundry charges of unusual character, or applicable to prior years, etc. (20)	3,325
Total debits (47)	$ 70,849
Profits with deduction of above debits	$114,378
PROFIT AND LOSS CREDITS WHICH HAVE BEEN MADE TO SURPLUS:	
Profit on sale of capital assets and reductions in stated depreciation of prior years (3)	$ 7,913
Gain on own securities repurchased at a discount and retired (18)	1,156
Gain from cancellation of unpaid expense items previously charged against income (5)	7,304
Adjustment of unamortized bond discount in connection with refinancing	......
Dividends received on own stock held in treasury (1)	112
Sundry credits of unusual character, or applicable to prior years, etc. (4)	139
Total Credits (31)	$ 16,624
Profits without addition of above credits	$ 97,754

CAPITAL-GAINS TAXATION

Martin Atlas

The problem of taxing capital gains has long been one of much controversy. The income tax laws of the Civil War period did not differentiate between capital gains and other sources of income. As early as 1872, the problem of whether capital gains were income and taxable under the law arose in the case of *Gray* v. *Darlington*.[1] The Supreme Court there held that under the statute as it read: "Gains, profits and income for the year . . . next preceding" the collection of the tax, profits from the sale of an asset held four years were not income for the year in which taxed. However, "it may be inferred from the opinion that capital gains realized in one year could be taxed under the statute."[2] The problem arose again when the Supreme Court was asked to determine whether capital gains were included in taxable income under the Corporation Excise Tax of 1909, which taxed corporations on "the entire net income . . . received by it . . . during such year." In its decision in the case of *Hays* v. *Gauley Mountain Coal Company*[3] the Court clearly stated that such gains were to be included.

> . . . since a conversion of capital often results in gain, the general purpose of the Act of 1909 to measure the tax by the increase from invested property, leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the Act must be regarded as "gross income"; . . .

This same attitude was taken by the Supreme Court in its decision in the case of *Eisner* v. *Macomber*.[4]

> Income may be defined as the gain from capital, from labor, or from both combined provided it be understood to include profit gained through sale or conversion of capital assets.

It was further extended by a series of later decisions to include gains from single, isolated transactions.[5] Capital gains are, therefore, firmly established in law as income and taxable under the Constitution, and have been included in all the revenue acts since 1913.

Legislative Background

The following table reproduced from the Hearings before the Committee on Ways and Means on the Revenue Bill of 1938 summarizes the tax treatment of capital gains and losses from 1913 to 1937, inclusive.

Present Treatment of Capital Gains and Losses

The Revenue Act of 1938 provides for the taxation of capital gains separately from other sources of income. For purposes of taxation, only certain percentages of gains or loss are recognized as follows:

If assets are held 18 months or less	100%
Over 18 months but not over 24 months	66⅔%
Over 24 months	50%

Gains from assets held eighteen months or less are included with other income and subject to full normal tax and surtax rates but losses are allowed only to the extent of gains on such transactions; however, losses disallowed in one year (to an amount not exceeding net income) may be carried for-

[1] 15 Wall 63.

[2] Parker, L. H., "Capital Gains and Losses," *Tax Magazine*, Vol. xiv, No. 10, October 1936, p. 605.

[3] 247 U. S. 189.

[4] 252, U. S. 189, 207. cf. *Southern Pacific Company* v. *Iowa*. 247 U. S. 330, 335.

[5] *Merchants Loan and Trust Company* v. *Smietanka*, 255 U. S. 509; *El Dorado Coal Company* v. *Hager*, 255 U. S. 522; *Goodrich* v. *Edwards*, 255 U. S. 527; *Walsh* v. *Brewster*, 255 U. S. 536.

HISTORICAL SUMMARY OF TAX TREATMENT OF CAPITAL GAINS AND LOSSES, 1913–37, INCLUSIVE

Revenue Act	Income Year	Treatment of: Gains from Sale or Exchange of Assets	Treatment of: Losses from Sale or Exchange of Assets
1913	Mar. 1, 1913 to Dec. 31, 1915	Included with other income subject to full normal and surtax rates	Not allowed.
1916	1916	do.	Allowed only to the extent of the gains from such sales.
1917	1917	do.	do.
1918	1918–21	do.	Allowed in full against income of any kind.
1921	1922, 1923	*Assets held 2 years or less*	
		Included with other income subject to full normal and surtax rates.	Allowed in full against other income, but not against capital net gains.
		Assets held over 2 years	
		At the election of the taxpayer, capital net gains were taxable at 12½ per cent in lieu of the normal and surtax rates; but if such election were made, the total tax, including the tax on capital net gains, could in no case be less than 12½ per cent of the total net income.	Allowed in full against income of any kind.
1924	1924	*Assets held 2 years or less*	
		Same as 1921 act.	Allowed in full against income of any kind.
		Assets held over 2 years	
		At the election of the taxpayer, capital net gains were taxable at 12½ per cent in lieu of the normal and surtax rates.	Could be segregated from ordinary net income, and a tax credit of 12½ per cent of the capital net loss taken, but in no case could the tax be less than the tax (computed at normal and surtax rates) would be if the capital net loss were deducted from ordinary net income.
1926	1926–27	Same as 1924 act.	Same as 1924 act.
1928	1928–31	do.	do.
1932	1932	*Assets held 2 years or less*	
		Same as 1924 act.	Losses from sales or exchanges of stocks and bonds were limited to the gains from such sales. It was provided, however, that such losses disallowed in 1 year (to an amount not in excess of the net income) could be carried over and applied against gains from such transactions in the succeeding taxable year.[1] Other losses were allowed in full against income of any kind.
		Assets held over 2 years	
		Same as 1924 act.	Same as 1924 act.
N.I.R.A.	1933	*Assets held 2 years or less*	
		Same as 1924 act.	Losses from sales or exchanges of stocks and bonds were limited to the gains from such sales. Other losses were allowed in full against income of any kind.
		Assets held over 2 years	
		Same as 1924 act.	Same as 1924 act.
1934–36	1934–37	Percentages of gains or losses recognized	
		Period assets are held	Percentages
		1 year or less.	100
		Over 1 year but not over 2 years.	80
		Over 2 years but not over 5 years.	60
		Over 5 years but not over 10 years.	40
		Over 10 years.	30
		Capital gains so computed are included in net income subject to full normal and surtax rates.	Capital losses so computed are recognized in determining net income to the amount of the recognized capital gains: plus 2,000.

[1] The provision relating to the carry-forward of disallowed losses from sales or exchanges of stocks and bonds held 2 years or less was repealed by the National Industrial Recovery Act before it became effective.

ward and applied against gains in such transactions in the succeeding taxable year. Gains from assets held more than eighteen months are included on the basis of the foregoing percentages with other income and subject to normal tax and surtax rates or segregated and taxed at 30%, whichever method results in the lesser tax. Capital losses computed on the basis of the foregoing percentages are deducted from net income or 30% of such loss is credited agaist the tax, whichever method gives the greater tax.[6]

Tax Effect of the 1938 Change in the Treatment of Capital Gains

The tax effect of this change as compared with previous law is shown in the following table:

Net income subject to normal and surtax before $100 additional income*	Normal tax and surtax on $100 additional ordinary over net income	Comparison of Taxes on $100 Additional Capital Gains from Assets Held for Specified Periods at Various Income Levels Under Old and New Laws[7]											
		1 year or less		Over 1 year, but not over 18 months		Over 18 months,[7] but not over 2 years		Over 2 years, but not over 5 years		Over 5 years, but not over 10 years		Over 10 years	
		1938	1937	1938	1937	1938	1937	1938	1937	1938	1937	1938	1937
$5,000	$ 8	$8	$8	$8	$6.40	$5.33	$6.40	$4.00	$4.80	$4.00	$3.20	$4.00	$2.40
10,000	11	11	11	11	8.80	7.33	8.80	5.50	6.60	5.50	4.40	5.50	3.30
20,000	19	19	19	19	15.20	12.67	15.20	9.50	11.40	9.50	7.60	9.50	5.70
30,000	23	23	23	23	18.40	15.33	18.40	11.50	13.80	11.50	9.20	11.50	6.90
40,000	28	28	28	28	22.40	18.66	22.40	14.00	16.80	14.00	11.20	14.00	8.40
50,000	35	35	35	35	28.00	20.00	28.00	15.00	21.00	15.00	14.00	15.00	10.50
60,000	39	39	39	39	31.20	20.00	31.20	15.00	23.40	15.00	15.60	15.00	11.70
70,000	47	47	47	47	37.60	20.00	37.60	15.00	28.20	15.00	18.80	15.00	14.10
80,000	55	55	55	55	44.00	20.00	44.00	15.00	33.00	15.00	22.00	15.00	16.50
90,000	59	59	59	59	47.20	20.00	47.20	15.00	35.40	15.00	23.60	15.00	17.70
100,000	62	62	62	62	49.60	20.00	49.60	15.00	37.20	15.00	24.80	15.00	18.60
500,000	74	74	74	74	59.20	20.00	59.20	15.00	44.40	15.00	29.60	15.00	22.20
1,000,000	77	77	77	77	61.60	20.00	61.60	15.00	46.20	15.00	30.80	15.00	23.10
2,000,000	78	78	78	78	62.40	20.00	62.40	15.00	46.80	15.00	31.20	15.00	23.40
5,000,000	79	79	79	79	63.20	20.00	63.20	15.00	47.40	15.00	31.60	15.00	23.70

* Statutory income less exemptions and credits.

Revenue Significance of Capital Gains Taxation

From a revenue standpoint the taxation of capital gains and losses represents an important factor. The following table show the estimated revenue significance of capital gains in total tax collections for the ten-year period 1926–1935:[8]

INDIVIDUAL INCOME TAXES, 1926–1935—TAXES ON CAPITAL GAINS AND LOSSES, TAXES ON ALL OTHER INCOME, AND TOTAL TAXES
(In thousands of dollars)

Calendar Year	Estimated Taxes on Capital Gains and Losses[1]	Estimated Taxes on All Other Income	Total Taxes[2]
1926	225,485	506,986	732,471
1927	296,879	533,760	830,639
1928	576,001	588,253	1,164,254
1929	420,971	580,967	1,001,938
1930	−15,226	491,941	476,715
1931	−89,001	335,128	246,127
1932	−79,917	409,879	329,962
1933	16,167	357,953	374,120
1934	17,197	494,203	511,400
1935	85,257	572,182	657,439

[1] Net tax liabilities on profit and loss from the sale of assets irrespective of the period assets were held.
[2] Individual income of tax liabilities reported in Statistics of Income.

Status of Taxation of Capital Gains in the States

The following table prepared by the National Tax Association from questionnaires submitted to the various states during the summer of 1938 shows the status of the taxation of capital gains in the states. From it may be seen that 24

[6] Revenue Act of 1938, section 117.
[7] Source: *Barron's*. May 23, 1938, page ten.
[8] *Hearings before the Committee on Ways and Means. Revenue Bill of 1938*, page 116.

Status of Taxation of Capital Gains in the States

Compiled by the National Tax Association from replies to Questionnaires (Midsummer 1938)

State	Individuals				Corporations			Methods of tax	
	Law specifically		Regulations require inclusion	No income tax on individuals	Law specifically		No income tax on corporations	Treated as ordinary income when realized	Other Methods
	Taxes	Exempts			Taxes	Exempts			
Alabama			x		x			x	
Arizona	x				x			x	
Arkansas	x				x			x	
California	x				x			U.S. 1936	
Colorado (a)									
Connecticut				x	x			x(b)	
Delaware	x						x	x	
Georgia	x				x			x	
Idaho	x				x			x	
Iowa		x				x			
Kansas	x				x			U.S. 1936	
Kentucky	x				x			x(c)	
Louisiana	x				x			x	
Maryland	x				x			x	
Massachusetts	x				x			Flat 3%	
Minnesota			x		x			x	
Mississippi	x				x			x	
Missouri	x				x			x	
Montana	x				x			x	
New Mexico	x				x			x	
New York	x				x			½ rates	
North Carolina	x				x			x	
North Dakota	x				x			x	
Oklahoma	x				x			x	
Oregon	x				x			x	
Pennsylvania				x	x			x(b)	
South Carolina			x		x			x	
South Dakota		x				x			
Tennessee				x	x			x	
Utah	x				x			x	
Vermont		x			x			x(b)	
Virginia	x				x			x	
West Virginia	x						x	x	
Wisconsin	x				x			x(d)	
	24	3	3	3	29	2	2	27	4

(a) Questionnaire not answered.
(b) Corporations only.
(c) Gains on assets held more than two years not taxable.
(d) Capital gains treated as ordinary income except when subject to surtax for old-age assistance, etc. they are then treated as in the 1936 Federal Act.

Source: *Report of Committee on Capital Gains Taxation of the National Tax Association*, 1938.

states specifically tax capital gains of individuals and 29 specifically tax capital gains of corporations. Only 3 states exempt capital gains of individuals and 2 states exempt capital gains realized by corporations. Twenty-seven states treat capital gains as ordinary income when realized, while 4 states provide for other methods of taxation.

Economic Interpretation of Capital Gains As Income

The Opposition to Capital Gains Taxation.—Basically whether or not capital gains are income depends upon the definition of income. If, as to Irving Fisher, only that part of income which is spent is true income because only such income yields psychic satisfaction and is subject to capitalization, then it is not invalid to conclude that:

> The present method of taxing capital gains is illogical and unjust. Under the present practice, the mere change of investment, with no true income involved, may cost the taxpayer a huge penalty assessed against gains which are capital, not income, and which relate to transactions of many past, not to current years.[9]

To Professor Plehn[10] "Income is essentially wealth available for recurrent consumption recurrently (or periodically) received. Its three essential characteristics are receipt, recurrence and expendability." His conclusions with respect to capital gains are, therefore, that:

> Gains and profit on transactions outside of one's regular vocation or line of business . . . are of doubtful income character.

If, on the other hand, income is seen as Professor Haig sees it, as "The money value of the net accretion to one's economic power between two points of time,"[11] then not only should realized capital gains be taxed as income but also those accrued by means of a formula which

> will offer neither complete nor partial exemption but rather fair and full taxation of this class of income with gains and losses brought to account regularly . . .[12]

The quarrel over a proper definition of income has been a long one and it is not the purpose of this paper to dispose of either alternative view. It may be indicated, however, that Fisher's concept results in the equivalent of an expenditure tax since, as defined, only spent income is true income. An expenditures tax may have definite merits; it seems clear, however, that while rich people spend more than poor ones do, they neither spend proportionately nor as much as they have the ability to spend. Such a tax is, therefore, not in conformity with the principles of progressive taxation and may result in inequitable tax burdens. For purposes of an income tax aimed to tax individuals according to their ability to pay, it would seem that any item of receipt that adds to tax paying ability is a fit item for income taxation and as such capital gains may properly be regarded as a source of income.

Accepting capital gains as a source of income, opinion still differs as to whether such gains should be taxed and if they should be taxed whether they should be taxed as ordinary income or be allowed special treatment.

George O. May, in his article, *The Taxation of Capital Gains,*[13] leads those who plead for the exemption of capital gains from taxation, on the grounds of equity and revenue yield rather than the supposition that capital gains are not income:

> . . . it is believed that the revenues can be increased, tax avoidance greatly diminished, and greater equity secured by the abandonment of the rule of taxing of capital gains and, conversely, of allowing capital losses as a deduction from taxable income.

Similar statements have been issued by:

The Tax Simplification Board:[14]

> The best considered opinions of accountants,

[9] Fisher, Irving. *The Income Concept in the Light of Experience*, 1927, p. 19.

[10] Plehn, Carl C., "Income as Recurrent, Consumable Receipts," *American Economic Review*, Vol. XIV, No. 1, 1924, pp. 5, 10.

[11] Haig, R. M., "The Concept of Income" in *The Federal Income Tax*, 1921, p. 7.

[12] Haig, R. M., "Taxation of Capital Gains," *Wall Street Journal*, April 13, 1937.

[13] *Bulletin of the National Tax Association*, Vol. VIII, No. 3, December 1922, p. 78.

[14] Report, December 3, 1923.

actuaries and economists appear to us to indicate that the elimination of both capital gains and losses, even now, would result in no decrease in revenue to the Government over a period of years.

Mr. C. Mitchell, in the *National City Bank Bulletin* for November 1930:[15]

It (the capital gains tax) has created artificiality in the security market, in the credit structure and in interest rates. . . . This tax acts as an obstruction to the free transfer of property, whether it be securities, land or what not, retards business and encourages inflation.

Hon. Emanuel Celler, Representative in Congress from the State of New York, in calling for the repeal of the capital gains tax said:

This tax penalizes initiative and discourages acquisitiveness. It limits growth and penalizes success. . . . It has long since gone beyond the point of diminishing returns. . . . As a measure for raising revenue it has . . . failed. . . . A capital gain is not income.[16]

The Proponents of Capital Gains Taxation.—Professor Haig, whose views have already been stated, is among those who maintain that capital gains should be taxed. Equally comprehensive are the recommendations of the Committee on Taxation of the 20th Century Fund, Inc.

(1) The Committee recommends that capital gains or losses continue to be reported in computing the individual's income tax liability; but

(2) The Committee recommends a repeal of the present system of including in the computation only capital gains or losses that are actually realized and the substitution for it of a tax on gains or losses as they accrue even if not realized.[17]

The second recommendation goes beyond even the statements of Seligman, who holds that capital gains are income only if realized,[18] and Hewett, who differentiates on the basis of whether or not such gains are expressions of real income.[19] The justification of the taxation of capital gains on the same basis as other income is well summed up by H. M. Groves, in his pamphlet, *A Tax Policy for the United States.*[20]

It would be a grave mistake to abandon the tax on capital gains. . . . Such gains are usually of a fortuitous and unearned character and are highly concentrated in the returns of large taxpayers. From the fiscal point of view this income has more ability to pay than ordinary income. From the point of view of social control the tax on capital gains is very important. Much of this income is a direct result of speculation . . . the present system of granting favored treatment to capital gains encourages the reinvestment of corporate earnings, and the latter in turn is responsible for much of the overbuilding of plant capacity which has gone on in this country.

From this it appears evident that capital gains should be taxed and that they should be taxed at the same rate as other income, without a special top limit.

H. C. Simons sums up the argument for the taxation of capital gains as follows:

To eliminate both capital gains and losses in computing taxable income, however, would simply prohibit fairness in relative levies among persons. To do this or even to make the more moderate concessions of our Federal law is to undermine the very basis of our Federal taxation. . . . Any special treatment of capital gains per se also requires introduction into the law of arbitrary, unsatisfactory and unnecessary distinctions. . . . Special treatment of capital gains is especially objectionable for the opportunities it provides for deliberate evasion or avoidance.[21]

Simons suggests the possibility of including capital gains in full and allowing capital losses in full by computing the income tax on the basis of an averaging system.[22]

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[15] Pp. 182 and 183.

[16] *Hearings*, Committee on Ways and Means, Revenue Bill of 1938, pp. 393, 394.

[17] *Facing the Tax Problem*, p. 490.

[18] Seligman, E. R. A., *Studies in Public Finance*, p. 108.

[19] Hewett, W. W., *The Definition of Income and Its Application in Federal Taxation*, p. 31.

[20] Pp. 32 and 33.

[21] Simons, Henry C., *Personal Income Taxation Privileges*, pp. 151–2.

[22] The inequities of the annual accounting period and the suggestion for a longer accounting period based upon a moving average of income which overcomes the difficulties experienced in England and Wisconsin with

The plan is to tax individuals in the usual manner. At the end of a five-year period (arbitrary) the average taxable income for the period and the total tax on this average income is computed. If this amount is less than the total of his five actual payments by more 10% (arbitrary, to keep the number of claims within reason) a claim for rebate over the 10% may be made by the taxpayer.

The plan of the present writer, previously referred to,[22a] contemplated an averaging system of a similar type to that suggested by Simons, but in lieu of rebates on the excess of actual payments over 10% in excess of the average which might have serious repercussions on the revenue, it was suggested that the excess of annual payments over the average be carried forward from year to year and a refund in cash be made only upon the death of the taxpayer, except that possibly at his request low interest non-transferable bonds might be issued to him in the amount of such credit, these bonds to be redeemed by the Government or used for purposes of future tax payments.

Nearly all advocates of capital-gains taxation recognize that to tax such gains upon realization as if they had all accrued within the year opens the possibility of inequity. There have, in recognition of this, been many who believe that capital gains should be given special tax treatment. Mr. L. H. Parker, for example, maintains that:

> . . . in view of the substantial difference which exist in the nature of ordinary income and the income from capital gains, that consideration be given to a plan whereby capital gains would be subjected to income tax entirely apart from other income.[23]

the averaging device were discussed in the present writer's article, "Average Income and Its Use in Taxation," ACCOUNTING REVIEW, June, 1938.

[22a] *Supra* note 22.

[23] "Capital Gains and Losses," *Tax Magazine*, Vol. XIV, No. 10, October 1936, p. 610.

Secretary of the Treasury Morgenthau, in the *Treasury Statement* for December, 1933,[24] discussed the effect of the tax on delaying sales of property and suggested as a method of meeting this criticism the possibility of "the adoption of provisions taxing such gains at a reasonable flat rate or spreading them for taxation over the years in which they accrued."

There have also been suggested from time to time a number of devices for giving capital gains special treatment. The ingenuity of economists and others interested in the problem makes it impractical and extraneous to consider each of the many plans suggested, such as averaging devices,[25] granting relief to those gains which may be classed as exceptional,[26] using various inventory methods,[27] and reconstructing past year's incomes.[27a]

The British Treatment of Capital Gains

The New York State Economic Council, in its report[28] states that:

> The income tax on capital gains, which never has existed in England, should be abolished, or, if that be not possible, reduced to a small, uniform and definite per cent, as in the case of corporations so that when an individual invests his principal, with all the risks that are involved in any investment, he may have some assurance that he may be able to retain a reasonable portion of any profits made as a result of such investment.

Much has been made of the fact that Great Britain does not tax capital gains. In this connection, it should be stated that despite the concept of "annual" or recurrent income, the British courts have, on occasions, found casual or isolated transactions subject to tax, so that although,

[24] P. 4.

[25] Simons, H. C., *A Positive Program for Laissez faire*, p. 27.

[26] Wood, H. S., *Statement*, Hearings, Committee on Finance, March 12 to 15, 1934, p. 182.

[27] *Proceedings*, National Tax Association, 1915, p. 303, *et seq.*

[27a] *Report of the Committee on Capital Gains of the National Tax Association*, 1938.

[28] *New York Times*, November 24, 1934.

generally speaking, capital gains are not taxed (and consequently capital losses disallowed), a great deal depends on the individual case under consideration. Further, it should be indicated that the general public in Great Britain does not speculate on the stock market to the extent to which the general public in the United States speculates; furthermore, there are fewer reorganizations of corporations and hence, fewer offerings of new stock upon the market. This point was admirably discussed by Dr. Haig in his report on *The Taxation of Excess Profits in Great Britain*.[29]

> When one asks an Englishman why capital gains are not taxed the first reply is almost invariably a surprised and shocked exclamation to the effect that this would mean the taxation of capital and not of income. If one then asks whether a tax on the increased value of stock-in-trade is a tax on income or a tax on capital he usually forsakes argument on the basis of fundamental principle and pleads the practical necessity for a dividing line. As a matter of fact that dividing line is a thin and tenuous one. . . .
>
> The fundamental explanation of the British concept is probably to be found in certain facts in the general economic background of England. It is an old, conservative, economic organism where transfers are less frequent than in this country, where fortunes are less often made through trafficking in appreciating assets, where values are dealt with more largely in terms of income and less in terms of sale price and where, above all, the general conception of the economic structure is static rather than dynamic. . . .

In a more recent study of the problem resulting from an investigation of European methods of taxing capital gains, Professor Haig made the following statement:

> It has been shown: (1) that the exemption of capital gains in England is far narrower than it is commonly conceived to be; (2) that the partial exemption of capital gains under their law involves drawing an arbitrary line between taxable and exempt transactions, with uncertain and inequitable results as between individuals in substantially similar circumstances; (3) that the British themselves are far from satisfied with their formula, a Royal Commission having gone so far as to declare that "it cannot be justified"; (4) that the formula places a premium on the transformation of taxable income into exempt capital gains, a premium sufficiently substantial to give rise to tax avoidance and loss of revenue in spite of England's superior administration and her high degree of taxpayer coöperation; and (5) that the devices for tax avoidance cause investors to buy and sell securities at "unnatural times," with consequences for the market that may be expected to be accentuated under American conditions.[30]

Conclusions

It remains, therefore, to inquire into which of the widely differing opinions best meets the premise that an income tax to be economically sound should be progressive in accordance with the theory of ability to pay.

If capital gains are not considered part of income because they are not subject to capitalization, and only items subject to capitalization are considered items of true income, then it follows, as Irving Fisher maintains, that only spent income is true income. The income tax thus becomes an expenditure tax and the difficulties of such a tax have been indicated.

The separate taxation of capital gains would also be in contradiction to the principle of progressive taxation, for the combined effect of the several scales, one for capital gains, the other for other sources of income, cannot be made to conform to the effect of a single graduated rate scale applicable to the aggregate income.

When a source of income is split away from other sources, the high progressive rates lose their effect, and the revenue raised under any rate scale, when applied to separate parts, will fall below the revenue raised by the same rate scale when applied to the whole. To compensate for this loss of revenue, a rate scale for capital

[29] P. 72.

[30] Haig, R. M., "Taxation of Capital Gains," *Wall Street Journal*, March 29, 1937.

gains would have to be enacted that would seem entirely unreasonable.

There remains for consideration the position of taxing capital gains as an integral part of income. As has been stated, the income tax is predicated on the theory of ability to pay. Ability to pay an income tax is based on the amount of income a taxpayer has at his disposal during the taxable year or, to put it into the words of Dr. Haig, "the money value of the net accretion to one's economic power between two points of time." Obviously, capital gains enter into the accretion to one's economic power.

The problem is to account for capital gains in such a way that they will be taxed the same as any other source of income but will not be penalized by virtue of subjection to high surtax rates due to lump-sum realization. If it were possible to use an inventory method of income tax accounting, the difficulty would be eradicated but the intricacies of valuation defy practical applications. Equity could, however, be achieved if the accounting period were lengthened to five or more years, and tax liability determined on an average base with capital gains included in full and capital losses allowed in full so that sporadic gains from sales or exchanges of capital assets would not be penalized or favored by comparison with recurrent sources of income.

THE JUNIOR ACCOUNTANT: HIS PROBLEMS, RESPONSIBILITIES, AND TRAINING

H. T. Scovill

THIS PAPER is divided into five main sections:

I. Problems of the Junior Accountant.
II. Responsibilities within the scope of work assigned.
III. Breadth of responsibilities ordinarily assigned to the Junior.
IV. Training within the University.
V. Training while on the staff of the Certified Public Accountant.

Under each of these five main topics several subheadings were formulated based on first-hand, up-to-date ideas contributed by accountants now working as juniors or who have been juniors within recent years. (Too many times in writing and talking on the problems and responsibilities of certain classes of individuals inadequate attention is paid to the thoughts and ideas of those whose duties and destinies are under consideration). Letters were addressed to fifteen alumni of the University of Illinois who had completed the undergraduate course of training in accountancy and who are now engaged in public accounting. Some of the fifteen have had only one year's experience; most of them have had two or three years', while one has had six years' and one ten years' continuous experience as a junior or senior accountant. Most of them are identified with firms in Chicago or New York; one is, however, in a city of two hundred thousand, one in a city of one hundred thousand, and one in a still smaller community. Nine different accounting firms of various sizes are represented in the group.

The outline of the subject, showing the main topics and subtopics we proposed to treat, was mailed with each letter, asking the recipient to offer practical suggestions or comments on any topics which appealed to him. Originally only the interweaving of some of their philosophy with that of

the author was hoped for. But after reading the frank and comprehensive replies, it seemed better that they should constitute the main feature, while the author relegated his own ideas to a minor position. Here, then, are the viewpoints of some former honor students who have learned much in the ways of the auditing profession since graduation.

The first main proposed topic and its sub-headings as presented to the young men in question is repeated. This is followed by quotations from their letters and reveals their sane, frank, and at times humorous comments. The other topics with their respective sub-headings are then repeated, each followed by the responses of the young accountants.

A. *Problems of the Junior Accountant*

1. Satisfying senior accountants. Speed, accuracy, resourcefulness, tact, knowledge of accounting theory, knowledge of accounting procedure.
2. Reconciling theory with practice.
3. Preparing for C.P.A. examinations.
4. Other problems.

Quoted Comments on Topic A

1. *Satisfying Senior Accountants*
   a. *Speed*

"Speed in practical accounting is not the fast-writing, paper-flying type, but rather the sort of speed that is gained from eliminating useless work. This holds true for the working papers as well as the report sent in for typing.

"Don't get the idea that you are saving time by using a lot of abbreviations or leaving off ciphers, as $529. While clear to you at the time, your abbreviations may not be so clear to others. The best rule to follow is to "watch your senior and do as he does, or says to do." Never, under any circumstances leave off ciphers! Write out the full amount, $529.00.

"It is also unwise to try to save time by leaving off the headings of schedules, dates and other items which may be confusing to others.

"Speed can be achieved by eliminating useless facts and data. In checking unemployment taxes, for example, it isn't necessary to analyze wages into amounts paid to each employee. It is necessary to check only the tax, not to verify the payroll.

"Any work executed should be capable of justification by the use to which it is put. There is no other criterion so important.

"While lack of speed is a problem, there is usually very little that can be done about it (assuming complete training, and that full advantage is being taken of that training). The inherent characteristics of an individual determine whether or not he will be fast or slow, and the slow person should not sacrifice thoroughness in the attempt to attain a desirable speed."

"Of the problems listed, none seem as important as the problem of speed. This involves more than the ability to work rapidly; it implies the ability to sense comparative values contained in the work to be done. After working assigned problems in school for four years, an accurate solution seems to be the only goal without consideration for the time taken. I've never been thanked for spending an hour looking for a ten cent error, or spending two days on a material-and-supply inventory of a quarter of a million dollars when the entire inventory amounts to several million with perhaps four days allotted to the entire job. A glance at the time estimate sheets, and a few minutes spent with the senior in charge before starting a piece of work has proved helpful, although jangled nerves and white faces evident around the first of the year reveals that time is an important factor to any public accountant."

"The junior must be accurate, and at the same time possess speed. He should be

fast mentally, but the importance of knowing how to operate adding machines, calculators, comptometers, etc., should also be covered."

b. *Accuracy*

"Even Seniors with years of experience make simple mistakes, such as errors in footings, etc. The thing for the Junior to remember is to tie up his work whenever possible and to hand to his senior a finished schedule that is correct in every detail.

"Now, suppose that the analysis of general expenses made by the junior is off by $1.74 from a total of $983.52. It is a waste of time to look for so small an amount, so plug some column in the analysis such as Miscellaneous General Expense. Plugging isn't to be recommended except in cases where the total amount of an account is known, and a supporting schedule is off a trifling amount. Never plug asset accounts unless absolutely necessary.

"In reconciling the cash account of a clothing store, I was off by $6.00. While checking deposits, the owner came by and asked if anything was wrong. When he heard the trouble he said, to be exact, 'What the h——, add it to P. & L. I should be for paying you guys $25.00 a day to look for $6.00. Don't be so foolish'."

"There is no excuse for anything but accurate work. This point is under the Junior's control, and his progress varies directly with his accuracy."

"In satisfying senior accountants the junior must deal with many different types of men, and he finds that different seniors are pleased or irked by different abilities or deficiencies. I remember one senior who felt that every accountant should be able to add intermixed red and black figures of considerable size, with adding-machine accuracy. He also thought that I should be able to dictate confirmation requests and correspondence regarding some foreign accounts with the facility of a bank executive. But these are peculiarities. I think that you have listed the problems which are most likely to be faced by the junior."

"The responsibilities of a junior seem to be fulfilled by doing accurate work. My present belief is that accuracy comes first, speed second. Preliminary discussion and planning helps to cut all possible corners and then a serious attempt to do the outlined work in the shortest time seems to be the only solution. If this procedure fails to bring the time within the estimate, I believe a few remarks about the estimate may then be made with a clear conscience. Of course, these remarks must be kept strictly under one's breath, and come under your suggestion that a junior must have tact."

"Every in-charge man is interested in doing the necessary work in the least time—but the first desire of any accountant must be accuracy."

c. *Resourcefulness*

"In most small audits, this one trait (resourcefulness) is more fully used in reconciling cash than in any other part of the junior's work. I have found that a good procedure is first to think of the various ways in which the bookkeeper might go wrong, and then start to check on them. Don't forget that banks make mistakes, too.

"It is rather hard for a junior to be 'resourceful' in his first jobs. This trait will come to the front more and more as the junior becomes acquainted with the records kept and the methods used by the client.

"Special attention should be given to the 'side' books kept by the bookkeeper. Most bookkeepers keep these pet books, and they sometimes are of great help."

"A great many items come under this heading but the following are most important:

(1) Ability and willingness to grasp the entire situation on an engagement.

(2) Knowledge of the client's procedure for internal control concerning the work he is doing.
(3) Ability to recognize any deviation from (2) by the client's employees.
(4) Ability to recognize weak points in the client's procedure for internal control.
(5) Knowledge of the need for the work he is doing."

d. *Tact*

"Tact is of great importance to the junior in the small office where he deals directly with the client or staff rather than through the senior.

"When asking the client to explain differences, it is always best to word your questions in such a way as to make the person feel that you have probably overlooked something that he can help you find. For instance, if you bluntly state that the bookkeeper is short $30, the fellow will get nervous and start trying to pull explanations out of the air. On the other hand, if you state that there is a small difference in the cash account, and you wonder if you could have overlooked something, the bookkeeper feels that he can be of help to you, and usually the difference is accounted for.

"Whenever you do have a difference between your schedule and some account, always take the matter up with the bookkeeper. He can usually explain the cause. Usually the trouble will be cleared up by this statement, 'I didn't know just how to handle the entry, so I left it until you fellows came.' Your answer should be: 'Some of these things are sure tricky, all right.' Don't ever make a 'cute' remark or be condescending."

"The junior's relations with the client's employees is the yardstick by which the client judges his ability and very often the ability of the firm for which he works. Some points are:

(1) Criticism must be taken up with the senior and not with the client's employees.
(2) Persistent arguing is never desirable. The most striking example of this is a junior I had who argued for 45 minutes that, if two factories are erected at the same time, used for the same purpose, and alike in every respect except size, the small building will depreciate faster than the large one. He then admitted he took his stand merely for the sake of argument.
(3) Obtain books and records through the proper channels and avoid offending client's employees.
(4) Be polite and firm, but never overbearing and aggressive."

e. *Knowledge of Accounting Theory*

"Today, these are a necessity, and not a problem."

"I don't know—but I believe that college graduates going out into the 'field' absorb little more pure theory. Their's seems to be a problem of bringing the theory to work and learning more about accounting procedures."

f. *Miscellaneous Comments on Relationship between the Junior and Senior*

"In a large firm, the junior accountant must 'serve many masters,' although, fortunately, not all at the same time. The junior accountant should be quick to recognize what qualifications the senior accountant regards as especially important and strive to please in those points. Without exception, seniors expect juniors to be resourceful. Nothing seems to bother a senior so much as to have juniors ask trivial questions. In this connection, lack of experience in setting up working papers usually tempts the junior to ask for specific directions before proceeding. To avoid this, a junior would do well to study working papers prepared by seniors under whom he will work in order to avoid asking

questions, and still be able to turn in a good set of working papers."

"Perhaps a part of the same thing is the developing of an attitude toward the senior which will give him confidence in the junior's work. Part of this development can be achieved by asking numerous questions about the scope of the work, the time which it should take, and peculiarities which turn up. I feel it better to reveal a vast amount of ignorance, if necessary, in order to be certain that my superior thoroughly understands what I have done, what is still to be done, or what I did not do. Sometimes it is difficult to bring oneself to the point of asking how or why a thing should be done, for to ask makes one seem woefully ignorant, but I feel that the questions are worth while."

"There are only two additional items which come to my mind—(1) apply yourself to the work assigned you—don't talk or visit a lot with the employees of the client, or with other staff men of your firm assigned to the job, and (2) keep outgoing and incoming personal telephone calls at a minimum."

"Some firms have the in-charge man fill out for every man (after every engagement) a form on which he must specify his opinion as excellent, good, fair, or bad on such matters as accuracy, speed, appearance, relations with client, attitude, knowledge of accounting theory, knowledge of accounting procedure, etc. In addition, space is provided for any additional remarks he may care to make. It is one's record as described by these different men, and the type of working papers one turns in that, in part, decide how one will progress.

"In the matter of satisfying seniors, the junior will at all steps find himself in direct competition with temporary men—'the nomads of the accounting world.' His work will be placed beside that of gray-haired men who have been in the 'game' all their lives. He must make up largely in aggressiveness, accuracy, neatness, willingness to learn, and progress, what he lacks in experience."

"Speed, accuracy, etc., are important, but all are of no avail if the senior does not like you personally. Analyze each and every senior and make him like you, and your senior will reconcile your theory and practice, and show you how to pass the C.P.A.

"There are always lights and windows in a room. See that everyone is comfortable. Always do more than your share of carrying books and bags and remember that any job is good enough for you."

2. *Reconciling Theory with Practice*

"The first thing that comes to my mind under this heading is 'you'll never find it done the way the books tell you.' This is accounted for by the fact that a large majority of bookkeepers just 'picked-up' their knowledge. They do the first thing that pops into their minds, and this is usually the hardest way to do the thing. The type of theory used by most of the clients we run up against is the old 'we've always done it that way.' Don't try to be a crusader for better accounting methods and jump in to change things that are unchangeable. Most of the time you'll have to go along with the client in his way.

"One fellow enters in a book the exact detail of his daily sales slips and then posts from the *book* into his receipts book. He won't post from the tickets to his receipts book."

"The beginning junior will, at times, find it very difficult to reconcile theory and practice but he should make every effort to tie up the work he is doing with what he has studied. This is true for both accounting procedure in the client's office and auditing procedure as outlined by the senior. If this is not done, he is apt to lose himself as I did the first time I was confronted with a pure voucher system.

I could not understand its workings until I compared it step by step with something I had learned back in my first year at U. of I."

"I think every junior accountant finds reconciling theory with practice rather difficult. In practice, the junior finds the situation much different from what he learned in school. Very often the junior needs to know very little theory to carry out the work assigned to him.

"Reconciling theory with practice does present some difficulties. A particular treatment or procedure may be theoretically incorrect, and yet be a perfectly good short-cut in practice, where the system of internal check is known and it is evident that no misrepresentation, or error of consequence, will result.

"Most juniors appear to get lost in the details of some particular item—the reason probably being that they haven't stopped to determine the purpose or goal of the work they are doing on that item. One place where this is often evident is in the computation of unexpired insurance—several hours may be spent looking for a difference of a few dollars."

3. *Preparing for the C.P.A. Examination*

"A necessary part of this, in my opinion, is the completion of a reputable coaching or review course just prior to the taking of the exam. While the junior may not learn any new principles, he will discover new methods of solving problems and will concentrate on pet subjects used in the exams."

"In preparing for the state examination, I apportioned time approximately as follows: Theory, 1, law, 1, auditing, 3, and problems, 10. Of course, this program would not be satisfactory to everyone, depending mainly on college work taken. However, the large proportion of time spent on problems is justified I feel because of the large proportion of failures in problems. As to actual preparation for problem work, I would advise the student to work his own solutions and compare them with prepared solutions, rather than merely study prepared solutions. C.P.A. exams require students to solve problems and not criticize presented solutions.

"Another suggestion is to prepare physically as well as mentally for the examination."

"After graduation, overtime work and daily routine make it harder to get down to study. A definite schedule (adhered to) is the only solution—with possibly some 'cram' course to stimulate action, if one is to pass the C.P.A. examination."

"It seems to me that the best practice or preparation for the C.P.A. is working problems. No amount of theory is of value unless it can be translated into practice."

4. *Other Problems of the Junior*

"Temptations are many, especially on out of town engagements. In small towns he must be very careful as to where and with whom he is seen.

"Excessive friendliness with the client's employees is to be avoided; sometimes, depending upon the circumstances, this rule may even extend to eating lunch with them.

"The junior's work is monotonous, and, unless he understands the purpose of his assignment and loves his work, there is always the danger of taking short cuts, resulting in not doing all the work he should. In footing and examining cancelled checks and vouchers, it is easy to skip a few here and there with not the slightest twinge of conscience. In other words, he must consider his work more than just a part of a job."

"A possible problem which many junior accountants face is that of physical and mental health. The detail work which a junior does constitutes a severe strain on the eyes, and eye-strain often results in headaches. Auditors are often required to work at whatever desks or tables are avail-

able, so poor lighting conditions are often found. The auditor must keep in good mental health; he needs a lot of nervous energy to meet the time requirements of the engagement. Speed is essential. But, at the same time, he must not be a 'nervous' individual who is disposed to worry about little things, or he'll go crazy when things go wrong, when he overruns the time estimates, when new and tough problems rear their heads, when it is necessary to work night and day to meet a commitment date. So he has the problem of keeping himself in good physical condition during the winter overtime, and of developing a calm, philosophical, take-it-in-your-stride attitude without losing speed and efficiency."

"Coming under your heading of the other problems of a junior, I might be able to suggest one of the problems that has bothered me most during the past few months. Last year, being doubtful about my ability to do good work in the accounting field, I decided to submit my efforts to a further test—a year's work with the best public accounting firm I knew. If I failed, I thought it best to look for other work rather than go into an accounting department of some industrial company. If I succeeded, I figured public accounting offered the greater chance for advancement together with the advantage of getting better experience. The problem now is whether to use the 'recession' as an excuse for having a three months' vacation, or put it in along with the above mentioned test. In short, the profession seems to have the same soothing effect and security as sitting on a keg of dynamite."

B. *Responsibilities within Scope of Work Assigned*

1. Overlook nothing within the scope of the work assigned.
2. Take nothing for granted.
3. Call to the attention of the senior anything that seems to be at all out of the ordinary.
4. Other such responsibilities.

Quoted Comments on Topic B

1 and 2. *Overlook Nothing and Take Nothing for Granted*

"If you don't quite understand an entry, don't let it pass without making some inquiry even if it looks all right. The client expects you to ask questions, so don't be afraid to use the privilege. Never leave an item or entry without understanding it. It is necessary to understand more than the mechanism of the entry; look behind the entry and determine whether it reflects the truth or not. This will be especially true of journal entries. You'll find some of the most hair-raising things called 'journal entries' you've ever seen."

"I would like to add that all unusual items must be run down to their source, and that conclusions should not be drawn too quickly, for very often a few more minutes of thought will throw an entirely different light on a question."

"Take nothing for granted—a good rule. I believe most juniors abide by it zealously. I have heard one senior say that this is why he prefers young juniors to older more experienced temporary men."

3. *Call to the Attention of the Senior Anything that Seems To Be At All Out of the Ordinary*

"When a junior is assigned to any particular phase of an audit, he is entirely responsible for that portion of the audit. If he feels that he does not understand fully the scope or nature of his work, he should not hesitate to ask the senior for instructions. If the question is not of a petty nature, he will generally find the senior glad to give instructions, as the senior is likewise responsible for the work of all juniors and semi-seniors assigned to him. In general, the junior should never

hesitate to ask questions while still new with a firm, as he will find himself reluctant to ask questions after he has had a year or two of experience."

"I have nothing to add to your suggestions except to suggest that in calling points to the senior's attention, the junior do so in writing. In short, it has been my experience that good concise stories (narratives, outlines, graphs, or whatever lends itself to telling the story clearly) have saved me from censure several times. I recall an instance where I was pulled off an assignment before completing it. I told the senior what I had done, and then jotted down the steps I had been planning to take, those completed, those partly completed, and those which were as yet nothing but intentions. It so happened that in completing one of the steps which I had noted as almost completed, an important audit adjustment was disclosed. The senior thanked his lucky stars that I had put the point in writing, for he had forgotten all about it until he went over my notes. And I thanked mine, too, for one slip of a serious nature is enough to cost a junior his job. So I am strong for well-written stories. The seniors I worked for as a junior appreciated them, and I, in turn, look favorably upon the work of a junior which is accompanied by a good description of the work done and the points disclosed or the conclusions reached."

"The most important suggestion I could make at this point to a junior is to tell him to put or imagine himself in the senior's position, and ask himself what he would expect from a junior working under him. He should guide himself according to the answer he would give himself on that question. He should make use of plain common sense and judgment with a nice balance between the two. I think it is a common fault of juniors to want to try to assume the more important tasks of the audit (which belong to the senior) and to spurn the detailed parts of the examination. If the junior does not understand completely the work that has been assigned him, he should feel free to ask the senior to explain it more thoroughly. The junior should go to the senior with his problems, not to the client's employees. Any questionable points, whether or not they seem important to the junior, should be presented to the senior for judgment."

"A junior should never permit his own inexperienced judgment to settle something beyond his ken. Nor should he interrupt a senior when he's talking with the client (of course, that's just common sense). If the junior is sure something is out of the ordinary, he should incorporate it in his working papers."

"In connection with calling extraordinary items to the senior's attention, two comments might be made. One is that the junior should be sure that it is out of the ordinary and not something he has, for the time being, failed to see through. Another point is that the questions should be taken up with the senior, rather than with the client."

"The junior is responsible to the senior for his time. He will find that most questions are unnecessary, and can be answered by thinking."

C. *Breadth of Responsibilities Ordinarily Assigned to the Junior*

1. Verification of cash and bank
2. Verification of additions and extensions of inventories
3. Ageing of accounts receivable
4. Analysis of accounts
5. Other responsibilities

Quoted Comments on Topic C

1. *Verification of Cash and Bank*

"The cash end of a job will occupy most of the junior's time, so he should be well informed on this subject.

"Pay the closest attention to the amount shown by the check and the amount entered in the check register. If mistakes are overlooked here, it will be impossible to reconcile cash and the checks must be checked again. This happened to me once, and the stack of checks was about two feet high.

"It is the exceptional bookkeeper in a small business who reconciles cash between audits. We are the only ones who reconcile the cash in a large number of jobs. This is hard to believe. We have just finished a city job, and the cash in the special assessment funds hadn't been reconciled for *two years*. The treasurer 'knew' they were all right, but had never gotten around to do the job."

"Many accounting firms issue instructions to be followed in doing this work, and any deviation from these instructions must be approved by the senior. The junior, therefore, is completely responsible for all his work in connection with cash."

"It is in the field of cash balances and cash transactions (and related fields) that the junior does most of his early exploration. On a small engagement—even a new junior may be asked to follow the whole cash program as outlined by the senior.

"On all engagements he's almost certain to be in on the cash count. Here he will probably find some very interesting (and at times disturbing) experiences such as a president producing a petty cash fund from a 'roll' in his pockets.

"All verification of additions and extension (including the crossfooting of twenty-six column balance sheets) fall as one of the responsibilities of the junior."

2. *Verification of Additions and Extensions of Inventories*

"On this item the junior's responsibility extends only as far as the tests he makes in complying with the senior's instructions. He should indicate in his papers the extensions and the footings he has tested, such as—Extended every item over $200, scrutinized all others for correctness of decimal point, footed every third page, traced totals of every page to summaries, and footed all summaries. This procedure should be set down in writing and bear the approval of the senior. All errors that are found, not just large errors, should be made a matter of record.

"Pricing of inventory is very often a part of the junior's work along with additions and extensions of inventory. He should obtain specific instructions as to the type of items to be taken off the inventory for the price test. After having set these items down, he should obtain the senior's approval on the extent of his test.

"The senior should instruct him as to the sources to be used for the price test."

3. *Ageing of Accounts Receivable*

"This is merely a matter of accuracy which would make the junior fully responsible.

"The more difficult task is the examination of the accounts themselves. Here the junior should be alert to pick up unusual credits prior to and after the balance-sheet data. In this connection he should prepare a statement for a test of credits other than cash and should run down these credits to their source."

4. *Analysis of Accounts*

"The beginning junior will not usually find himself analyzing many accounts. His only responsibility will probably be to record accurately the explanation for entries and to examine supporting data. The reasonableness and correctness of the account should be left up to the senior."

5. *Other Responsibilities*

"It is surprising how little juniors know about types of insurance and information to be found in an insurance policy. A detailed examination of policies is not necessary, but a scrutiny of the typewritten matter may reveal important information. For instance, I know of one policy that

indicated the company had a contingent liability in the form of an option to purchase a building.

"The junior should be certain that he has seen all policies that have been charged either to the prepaid-insurance account or to the insurance-expense account. And he must be sure that all policies have actually been charged into one of these accounts."

"There are a good many types of audit work which I have been required to do as a junior which are not listed on your sheet. Some of them are:

Vouching purchases and sales of securities (stocks and bonds, etc.).

Verification of the pricing of inventories and comparison of inventories as carried on the books with the market values of such inventories.

Circularization of receivables.

Vouching property additions and reductions.

Counting securities (stocks, bonds, etc.).

"Search for unrecorded liabilities (usually as a junior I was assigned to only a part of the search for 'unrecordeds,' such as inspection of all vouchers covering the period from the audit date to the date of completion of the field work, the inspection of all loose invoices which the client's employees could and would present for my inspection).

"I have also reviewed and made (or dictated) excerpts from the minute books of subsidiaries (and later of parent company), but I do not think that the junior does this very often. I'm not sure."

"The following list might be added to the items on your outline:

1. Detail property verification.
2. Circularization programs—accounts receivable and accounts payable.
3. Unrecorded liabilities—examination of subsequent-period vouchers."

"With certain groups, staff juniors may find it their lot to act as in-charge men of the bags and pencils."

D. *Training within the University*

In listing this topic, the addressees were advised that their *alma mater* had altered the requirements for graduation in accountancy so that they now require a course in speech and one in report writing. These are referred to in several of the replies.

Quoted Comments on Topic D

"How many beginning juniors can set down on paper the pertinent facts of a problem obtained from a set of books and arrive at the conclusion they want? One very definite help would be a laboratory course in which the student would do nothing but prepare complete sets of audit-working papers from actual books and supporting data."

"My ideas on training are not very definite yet, but I believe that the U. of I. curriculum is pretty good. I am glad to hear of the inclusion of more writing, since I have often been disappointed with the stories in our working papers. The simplest things are sometimes made to appear complicated because of the junior's inability to write a clear, concise, statement of facts and conclusions.

"We must learn to think more, but I don't know whether to agree with Dr. Hutchins and his ideas about the classics or to advise more problems.

"Personally I have needed more training in consolidations, but that resulted perhaps from my being thrown in to check a rather rough consolidation before I had had any extensive experience along this line."

"In addition to the usual accountancy courses, it is very important to include courses in Speech and Report Writing. Many graduates of universities are given an excellent background in accounting theory, but lack the facility of cogent expression."

"I'm very much in favor of the addition

of the two new courses, since I am constantly impeded by my lack of ability in writing and speaking. I believe most young fellows will admit the need and importance of this work but their weakness makes them avoid the effort necessary to improve themselves. The opportunity to substitute one or both of these courses will probably help but I wish they had been compulsory when I was in school."

"More weight should be placed on the writing of reports and certificates and drafting of financial statements."

"It seems to me that the training given at Illinois is as good as, if not better than, that received by any of the 1937 graduates employed here.

"The addition of report writing is excellent. It seems to me that there is much room for improvement in reports written by accountants. Turning out a good set of working papers and writing a good report from those papers seem to be two different jobs."

"Working on a small set of books while going to school, preferably during the summer, will teach the student the best way to reconcile theory with practice.

"Summers are suggested for working since it is important to engage in other school activities while school is in session. A junior accountant must know how to contact people, and school activities afford an excellent opportunity for development."

E. *Training While on the Staff of the Certified Public Accountant*

"Preparation of working papers, routines, and policies of firm, manners and mannerisms of speech, dress, and relations with staff and clients."

Quoted Comments on Topic E

"The best thing a junior can do for preparing working papers is to take an old set of papers and go over a job before starting on the current year's work. Being required to make the set-ups, he should know what to include in them.

"As to mannerisms of speech, dress, etc., the best thing to do is to forget that you ever went to college. Relegate your activity keys, along with your loud socks and flashy ties, to the old trunk, and be a neat, conservatively dressed, English-speaking (no college slang) young accountant. Don't go about the client's staff telling of 'When I was in college . . . .' For some reason, those who haven't been to college faintly dislike those who have. Be friendly, but never familiar. Speak respectfully to your client. The senior may call Mr. Rosenblum 'Jake,' but you stick to Mr. Rosenblum."

"After leaving school, the individual is usually fed up with books to such an extent that he does not care to look at them for a while. This should be overcome as soon as possible, and constant review and reading of new matter must be taken seriously. To encourage the adoption of this attitude, the University could obtain magazines such as the *Journal of Accountancy* at reduced rates for its graduates."

"I am not competent to discuss training after leaving the University. I take the ACCOUNTING REVIEW and the *Journal of Accountancy*, and read parts of them; occasionally I really study a good article, but for the most part I skim through them. It is difficult to take any night or review courses because of overtime on almost every engagement, and because of the ever-present possibility of being sent out of town. Our library is fairly good, and I buy new books occasionally. (I have just finished the new *Statement of Accounting Principles*, but am not very enthusiastic about it as yet.) I haven't tried correspondence courses but I think I could devise a plan of study which would be fairly satisfactory and more interesting than one prescribed for me. But I have

not taken the time to organize such a plan of study. My inclinations run to—

The state laws
Registration statements
Controversial theoretical problems which are being discussed
Statements for annual reports and footnotes
Auditor's certificates."

"After leaving the university I think it wise for the junior accountant to learn to make friends, and maintain contacts, so that in the future he may be able to get business for the firm."

"The desirability of reviewing working papers on completed assignments so as to become familiar with analysis work and methods of approach."

"Here's another thought: 'Put things away where you found them!' It will help your relations with the staff and the clients.

"A junior must learn to think on paper in an orderly fashion as well as intelligibly, legibly, and accurately in the eyes of anyone. Here's the advice one senior gave: 'Don't omit necessary comments from your working papers, but be able to stand back of your working papers on the witness stand!'

"Conservatism and neatness seem to be the rules of dress. I have been told of one firm which greeted incoming juniors, and then told all 'hatless' ones to report back after getting something on their heads.

"Unless you get along well with the staff, you can't hope to hold your job; unless the firm (of which even the youngest junior is a front-line representative) impresses the client favorably, return engagements may be lost.

"Good manners are always in order. Good reason must always supplant training, rules, and firm policy and simple 'horse-sense' plays a greater part in accounting decisions than many college seniors realize."

"One handicap that the junior is likely to encounter is the question of what constitutes reasonable verification. This is one case where it will be valuable to go over a set of working papers rather carefully. One of the profitable ways a junior can spend his first few days is in looking over papers from previous engagements, and endeavoring to ascertain what occurred during the preparation of the schedules.

"One of the first things the junior should realize is that his employer has been in business longer than he has. This shouldn't discourage his making suggestions, but the firm will have established more-or-less definite forms for working papers and statements, and the junior should learn the forms and follow them.

"In general, a quiet, reserved manner of speech and dress is desirable. One case that happened here is that of a man who probably did excellent work with his chair tilted back and his feet up on the desk, but the client would have thought he was getting more for his money if the junior had been sitting erect at this desk, busily figuring his own budget for the next two weeks."

"Again reliance must to some extent be placed on a helping hand from the senior provided he likes you. Good juniors are made by the seniors and each senior will take off a rough edge. Try to follow the judgment of the others on the staff in respect to manners, speech, dress, and relations with clients, and do not try to formulate a new code of living until you have graduated to a higher position. A junior should also remember that college dress is usually improper in a business office."

There is little to add to these quotations, containing such sound advice and frank comments on the problems, responsibilities and training of the junior accountant. A junior accountant should recognize that his problems, responsibilities, and training should make him the best possible type of

accountant to serve his organization, clients, and society. These requirements are nicely set forth by one of the alumni in what he calls "the general characteristics and attainments required of a successful public accountant."

"1. A sound education in accounting theory, auditing procedure, economics, principles of internal control, law, taxation, and other related subjects.
2. Ability to express ideas and facts in clear, concise and understandable language.
3. Studiousness and perseverance; a real desire to keep up with latest developments in accounting subjects and everchanging tax laws, and an unwillingness to finish a job or draw a conclusion until he is sure he is right.
4. Judgment—ability to put accounting theory into practice and to recognize a situation where strict theory should be disregarded in favor of alternative treatment which presents the facts more accurately. These situations arise frequently, and when they do arise, it is extremely dangerous for an accountant who is not thoroughly familiar with accounting theory to make the decision.
5. Tact—ability to handle assistants and clients.
6. Willingness to accept responsibility.
7. Executive ability—to be able to organize an audit efficiently and to supervise more than one engagement at a time.

"The first three requirements are necessary for assistant accountants in increasing degrees during their progress as assistants.

"The fourth and fifth requirements are essential for a good in-charge or senior accountant.

"The sixth requirement should really be necessary for a good in-charge or senior accountant, but is absolutely necessary for advancement beyond that stage. I have known reasonably good in-charge accountants, however, who lacked the sixth requirement, and relied on their supervisors.

"The seventh requirement is absolutely essential for an accountant to rise above the rank of in-charge accountant.

"In my experience most accountants have lacked requirements three, five, six, and seven. It is surprising how many otherwise good accountants are unwilling to accept responsibility or are unable to handle more than one engagement at a time."

CORPORATE DISTRIBUTIONS AS INCOME TO STOCKHOLDERS

HARRY D. KERRIGAN

If corporate profits as they are made accrue to the corporation alone as a separate entity, they cannot be taken up as income by stockholders until profits are distributed by the corporation.[1] Distributions by corporations differ in amount, frequency, and medium of pay-

[1] The reference here is, of course, to corporations other than those identified with closely-held control. The fact that a corporation is a legal entity is not, considered by itself, sufficient to set up the distinctions between stockholder and corporation emphasized in this study. The interposition of a corporation so that assets are held by a legal entity instead of individuals does not remove control by a few persons if the capital stock of the corporation is closely held.

ment, but all are popularly known as "dividends." Some dividends are stated amounts paid at stipulated intervals; such is the case of dividends on so-called preferred stock. Other dividends are unstated before actual declaration by the directors' resolution, both the amount and the frequency of the dividend being left to the discretion of directors in accordance with the contractual terms of the shares owned by the stockholders. This is the usual arrangement under which dividends on common stock are paid.

Variation also exists in the medium of dividend payment. The most important medium used is corporate assets, cash being by far the leading specific asset used. Another form is the distributing corporation's obligations, scrip or note payable being the common forms. The third principal medium is unissued capital stock.

Criterion of Realization

A number of difficult questions appear in imparting the character of income to corporate distributions in the hands of recipients. One such difficulty—the allocation of income to a particular moment of time (moment of receipt) when income is created over a period of time—concerns all dividends regardless of the medium of payment. As already stated, income is a flow, implying a period of accrual. Practical considerations, however, were seen to permit but a partial observance of this fundamental fact. The limitation came from setting up the act of realization as the occasion for measuring the flow and taking up as income by a particular person, corporate or individual. If this principle is accepted it follows that a person's investments may become more valuable, but that such enrichment is not income to him until realized.

Adoption of the requisite of realization has introduced another difficulty; it raises the issue of what constitutes realization. The problem is to define those items of receipt which have the attributes of income in hands of recipients. The inquiry of the present study involves only part of this broad field. Stated specifically, our question is: Does the receipt of corporate dividends declared from earnings in the form of corporate assets, obligations, or unissued capital stock, constitute the receipt of income by stockholders?

Three Conditions for Realized Income

The problem is clarified if the conditions which appear to be necessary before any of the items of receipt mentioned can be deemed to be income are first stated. Three conditions would seem to be necessary: First, the thing received must have a determinable fair market value.[2] Second, it must be subject to recipient's separate use, benefit and disposal. Third, it must be a gain, i.e., leave the recipient's investment in question unimpaired.

Two tests are available to determine whether or not impairment of investment has occurred. Under test one, the acquisition cost of the investment in question may be compared with its fair market value after the receipt of the particular dividend. If the market value so determined is at least as great as the original cost of investment, no impairment may be deemed to exist.[3] Under test two, acquisition cost is segregated at time of purchase into (1) book equity as shown by corporation's latest balance sheet, and (2) market equity.[4] The investment to be preserved is

[2] Measurability of the item may here seem to be confused with the nature of the item itself. The impression is easily corrected if measurability is viewed as but one element of the problem of identifying the item, the other elements being those mentioned in the next two sentences of the text.

[3] Dollar amounts are the subjects of comparison here, fluctuating purchasing power of the dollar being ignored. Fair market value is conceived as a comparatively stable value independent of speculative or short-term market fluctuations due to passing idiosyncrasies of the stock market.

[4] On the ground that earned surplus should alone

then considered as the sum of these two elements. If the sum of book equity alone after a dividend is at least as great as the book equity at acquisition date, no impairment may be considered to have taken place, provided that no decrease in market equity purchased has been sustained during that period.

The second test allows greater conservatism. In the event that the book equity of the original stock immediately after a dividend is smaller than that which existed at acquisition date, a sufficient allocation is made from the dividend receipt to keep intact the book equity at acquisition date as shown in the investment account, the remainder of the dividend constituting income.[5] This would be the procedure even though the fair market value of the original stock after the dividend still is at least as great as acquisition cost.[6] It is believed that the second test is superior to the first because in its application dividend income is restricted to corporate earnings made during the period the investment is held.

An example applying test two will be given later in the discussion dealing more directly with stock dividends.

DIVIDENDS IN CASH AND CORPORATE OBLIGATIONS

Ordinary dividends paid in cash constitute income upon receipt if it be admitted that any realized money gain is income.[7] Money income is the closest practical thing to real income evidenced by consumable commodities and services. This is the chief virtue of income received in cash. However, the receipt of money's worth has come to be recognized as the equivalent of money because the bulk of business claims are not actually liquidated in cash. Thus "cash dividends" are commonly paid by check which are taken up as income upon receipt. The same is true of other corporate assets received as "dividends in kind" and treated as being the equivalent of cash. The term "cash equivalent" is generally applied to any corporate asset received as an ordinary dividend provided the item of receipt is realizable in cash at the pleasure of the recipient.[8] That this is sound from the standpoint of practical administration is clear to everyone. That it is also sound in theory is seen from its conformity with the tests of realization adopted above.

May the foregoing reasoning be used to justify taking up ordinary dividends received in the form of obligations of the dis-

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serve as the source of dividend income, book value as shown on corporation's balance sheet at time stock is purchased or at some nearby date should be reduced by unrealized appreciation surplus. The effect of this necessary refinement of "reported book value" is to increase the portion attributable to market equity.

The purchase cost of the stock may be smaller than book value (even after the adjustment referred to in preceding paragraphs), in which case there is a market discount instead of a market premium. The market premium or discount usually fluctuates with prospective earning power and the idiosyncrasies of the stock market.

Having just noted that the cost of an investment may be less than book value, it is apparent that the stock purchase price in such a case would represent book value less market discount. A generalized statement of the investment to be left intact for purposes of determining income therefrom follows:

The investment to be left intact is the algebraic sum of (1) book equity as shown by the corporation's balance sheet nearest available to date of stock purchase, and (2) market equity.

[5] An example illustrating this point in the case of a stock dividend received has previously appeared.

[6] This test proceeds somewhat along the lines followed in parent-subsidiary accounting in which dividends out of earned surplus at date of acquisition are deemed a return of investment, instead of income, to the parent company.

Under test two, increase in market equity (i.e., increase in market premium or decrease in market discount) since acquisition date is ignored because such increase is unrealized appreciation. However, a decrease in market equity (i.e., a decrease in market premium or increase in market discount) below what was originally paid after a dividend is received is reflected in the measurement of income from the dividend, even though there is only a "paper" loss. The ground here is that of conservatism.

[7] Note the requisite of gain, that is, the cash dividend received must leave the recipient's investment in question unimpaired as disclosed by test two described before.

[8] The time reference here is to the present, i.e., realizability in cash at date item is received. The measure of the income is thus the present or cash value of the item of receipt, provided that the investment is left intact according to test two described above.

tributing corporation? If the problem is viewed solely from the recipient's standpoint, the question raised clearly calls for an affirmative answer. It is immaterial for the recipient whether he receives as a dividend the distributor's own bond or note or the bond or note of some third party formerly held among the assets of the distributor so long as the three tests of realization are met.[9]

May the same be said of dividends received in the form of capital stock of the distributor? The consideration of this question is reserved for the section following.

STOCK DIVIDENDS

Into the discussion of whether or not a stock dividend is income, an element of confusion is introduced by the practice of passing back and forth between two fundamentally different conceptions of the nature of a share of capital stock held by the stockholder.[10] The shifting of the bases of reasoning is probably done unconsciously; nevertheless, it creates confusion and controversy. One conception, discussed at length in an earlier section, is that a corporation is a separate entity and that owners of its capital stock hold contracts with the corporation. From this starting point, the analysis proceeded to show a number of implications logically following the main premise. The more important of these implications may be restated here in summary form in order to sharpen the focus on the issues that are involved. (1) The ownership of the assets is vested in the corporation as a separate "person." (2) The same is necessarily true of the income from the corporate assets. (3) From (1) and (2) it follows that no income of the corporation can be taken up by its stockholders except on the occasion of corporate distributions of dividends. (4) The evaluation of the dividend is solely viewed from the standpoint of its effect on the recipient, three conditions being set up to govern the evaluation. These conditions are (a) determinability of a fair market value for the dividend, (b) disposability of the dividend at recipient's will and (c) presence of gain in the dividend.

The other conception is that a corporation is in reality an association of stockholders. The ownership of the corporation is vested in the body of stockholders through the shares of stock which measure their equity at a particular time. Income to the corporation is automatically income to the stockholders. This means that a stockholder should take up his pro-rata share of corporate income as the corporation reports it.[11] When a dividend is received which reduces the stockholder's equity in the corporation, the result is an exchange of assets with no effect on income.[12] For the stockholder the divi-

[9] The measure of the income of a bond or note dividend is determined in the same way as that used for corporate assets other than cash. See *supra* note 22.

[10] Again, it must be remembered that reference is had to corporations other than close corporations. See *supra* note 14.

[11] The cost to a stockholder purchasing stock of a going business represents two distinct things: book value plus market premium or less market discount (see *supra* note 18). The use of the accrual method discussed in the text would logically require a separation of these two elements. The book value portion of the investment is then increased by taking up pro-rata share in earnings of the corporation as reported and decreased by distributions. Changes up or down in the market premium or discount portion of the investment will of course occur, but these may be ignored until the investment is sold. The segregation of the two elements is, to the writer's knowledge, not followed in practice, but the advantages of such a procedure are discussed at length in Preinreich, G. A. D., *op. cit.*, pp. 4 to 19.

[12] Under the view discussed, a stock dividend of common on common would leave the common stockholder's book equity unaltered, when the comparison made is immediately before and after the receipt of the dividend stock. The change would be interpreted to be merely in the symbols representing that equity. A dividend of this type therefore does not occasion an exchange of assets under the view discussed in the text. A difficult problem would, however, be met if the stock dividend is one paid in different stock. Equity in a corporation having different classes of capital stock must of necessity be subdivided in terms of equity of each specific class. The recipient of a stock dividend of the type referred to would have to investigate the status of his particular

dend constitutes an exchange from one "pocket" to the other. The treatment of a dividend as an additional asset with a corresponding increase of income would clearly lead to double counting of the same income, first when it was earned and, second, when it was received as a dividend.

The implications of the two opposite conceptions throw into bold relief the contrasting views on the nature of a stock dividend received. From one approach, stock dividends may properly constitute income in the recipient's hands provided certain conditions are fulfilled; from the other approach, no dividend received is income, the income having been taken up when first reported by the corporation. Both conceptions furnish satisfactory starting points from which to build a rational theory of stock dividends. The dictates of logical reasoning, however, prevent the straddling of the two conceptions (employing one until necessity impels a shift to the other in the consideration of the same problem).

It is characteristic of the argument of those who oppose the treatment of stock dividends as income to premise part of their reasoning upon the first conception and part upon the second. The first conception is used to deny identity of corporate income with income to stockholders. From this a shift to the second conception is effected, midway in the argument, in order to deny that stock dividends are income upon receipt. It is argued as logically following the second premise that a stock dividend leaves unaffected the proportionate interest of the stockholder in the corporation. The whole interest of the stockholder after a stock dividend is stated to be still that of a stockholder. Not only is the nature of the interest the same both before and after the dividend but the extent of that interest is also unchanged because the pre-existing proportionality of interest continues unaltered. Furthermore, after the dividend the stockholder still has nothing but stock. Thus, there is no new or additional interest passing to the stockholder, the dividend stock received being considered as merely a part of what has belonged to the stockholder all along.

Another argument also in harmony with the second fundamental premise is that no separation of gain from corporate assets attends the payment of a stock dividend. Instead of being distributed, the earnings are placed back into the business where they can no longer be distributed at some future time. If the corporation parts with nothing, if the fruit is not separated from the tree of corporate assets, the stockholder does not receive anything.

Perhaps the most serious flaw in the logic of the position just described is that it suffers from inconsistency: the inconsistency of employing two contradictory conceptions upon which to build an analytical structure. A more solid ground for dissent from a reasoned position is scarcely possible. Besides this fundamental weakness, however, there are a number of specific points which throw further doubt upon the validity of the position under consideration. In the first place, those who favor this position make it clear that they are discussing only one type of stock dividend, namely, common on common.[13] The

book equity as a result of the dividend in order to take suitable action as to how to treat it upon his books.

[13] "In this paper we shall not discuss stock dividends payable in preferred or upon preferred . . ." but "the standard case of the stock dividend . . . in which . . . common . . . are distributed upon . . . common . . . the two classes of stock becoming after the dividend indistinguishable in respect to voting and dividend and other rights, and in respect to liability." Whitaker, A. C., "Stock Dividend Question" (1929), 19, *American Economic Review*, 23.

"All of my discussion has considered only dividends declared in stock of the same character as that upon which the dividend was declared. In . . . [other cases] . . . conditions may exist eliminating . . . opposition to . . . stock so received as . . . income." Herrick, Anson, *Address before American Institute of Accountants*, Colorado Springs, October, 1930.

Since *Eisner* v. *Macomber* dealt with a stock dividend

best that the theory can do is to cover one of several types used in practice. Such a theory is but a partial theory and causes well-founded doubt as to its applicability even to the type to which it is professed to apply because of the failure to recognize the close similarity between the various types. It is also contended that the recipient of a stock dividend experiences no gain as a result of the dividend.[14] The old plus the new shares represent the same value that the old shares did alone. The answer to this is that exactly the same thing is true when a cash dividend is received; the shares plus the cash dividend represent the value of the shares before the cash dividend. Appreciation in the market value of a person's assets, if not accompanied by realization, results in no income to him, but gain realized from an increment in the market value of his assets is income even though immediately after realization the person is no richer (as judged by the market value of all assets held by him) than he would have been if there had been no realization at all.

A POSITIVE THEORY OF STOCK DIVIDENDS

The view that a stock dividend is not income may be demonstrably unsound, but opposition to it loses much of its force if there is no alternative which commends itself as superior. It is believed that there is an alternative doctrine that is superior both from the standpoint of sound theory and practical usefulness. The proposition is that a stock dividend, under certain conditions, may properly constitute income in the recipient's hands.

Probably the strongest support for this proposition comes from its consistency with the underlying premise that the corporation is a separate entity. The entity theory was observed to be in keeping not only with the legal concept of a corporation but also with substantial economic truths of the corporate situation generally as it exists today. In fact, it is only by regarding the corporation as an economic and legal entity distinct from the stockholder that any dividend—irrespective of the medium of receipt—can be regarded as income to the stockholders.

In the second place, the receipt of a dividend stock constitutes a realization that is certain and definite enough to warrant the recipient thereof to take it up as income. It is only upon realization that any income is shown, but realization does not necessarily imply the receipt of cash. Accounting practice has long sanctioned the determination of income based upon goods sold upon the establishment of a valid claim, evidenced by a note or open account, against the purchaser. The same is also true of dividends received in corporate assets other than cash and in obligations of the dividend-paying corporation, all of which are deemed to constitute realized income when received. What is realized by the recipient of dividend stock is additional assets in the shape of a marketable security.

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of common on common, the majority opinion in that case and the commentators who agreed with the opinion were considering a particular type of stock dividend. The featured argument that no new or additional interest is conveyed by the stock dividend is clearly more convincing in the case of a stock dividend of common on common than in the case of other types of stock dividends. The United States Supreme Court in *Koshland v. Helvering*, 298 U. S. 441 (1936) came to this conclusion when confronted with an income tax case involving the receipt of a dividend of common shares on preferred. See discussion of this case, *supra*, Chapter III, p. 86.

[14] The argument of absence of gain attendant upon receipt of a stock dividend is presented in the following articles: Siegel, S. N., "Stock Dividends" (1932) 11, *Harvard Business Review*, 76; Whitaker, A. C., "Stock Dividend Question" (1929) 19, *American Economic Review*, 20. The suggestion is ventured that these writers and others probably are referring to absence of increase in the book equity of a given stockholding. If this is the intended thought, in spite of the different meaning which the words used carry, it is of course correct to say that a cash dividend decreases a particular stockholder's book equity and that a stock dividend does not.

But this clarification is of no help to the contention made, namely, that a stock dividend is no occasion for enrichment. The answer made in the text, to the effect that neither does a cash dividend bring enrichment, still appears valid.

Thirdly, the receipt of a dividend stock may represent a realization of an increment of wealth which arose subsequent to the purchase of the investment. The time element is important in this connection, as it is with respect to any phase of the income question. A comparison of the recipient stockholder's status before and after the receipt of the stock dividend should compare the status, not immediately before and after the receipt of the dividend, but the status at the date the investment is purchased upon which the dividend is received, with the status after such dividend. This interpretation is therefore articulated with the fundamental principle that income is created over a period of time. The comparison made to ascertain if a realized increment in a person's wealth had taken place is not a comparison between two adjoining moments of time, but between the beginning and end of a more or less prolonged period of time. Any dividend—irrespective of the medium of receipt—is necessarily a dilution of the worth of the stock on which it is received when the comparison is made between the moment after the receipt of the dividend and the moment before. The theoretical drop in the market price of a stock, to the extent of the dividend amount, immediately after the stock goes ex dividend is just as true for stock dividends as for other types of dividends.[15]

In sum, the receipt of dividend stock—evidenced by a negotiable stock certificate—which leaves the investment of the original stock on which it is received as great or greater than that which existed at acquisition date constitutes realized income fully as much as, say, the receipt of an obligation of the paying corporation or of a security of a different corporation held by the former in its investment portfolio.

The foregoing view that a stock dividend may properly constitute income at time of receipt has two other grounds for support, which are stated below.

(1) The stock dividend device is fundamentally the combination into one of what are two distinguishable steps. The two steps are (a) distribution of cash and (b) simultaneous re-investment of the cash in additional capital stock. From the corporation's side, a stock dividend denotes two separate though related actions. On the one hand, it expresses the belief of the directors that earnings warrant a distribution to stockholders; on the other hand, it expresses the belief of the directors that future prospects warrant the re-investment of the funds subject to the distribution, making for increased capitalization. The second step, though simultaneous in time with the first, represents financing through a "private" instead of a "public" market. From the stockholder's side also the stock dividend denotes a double operation, the same as if a dividend had been declared and paid in cash which was immediately used to acquire more stock. Whether the stock purchase was made

[15] The amount of decrease in market value of a stock when it goes ex dividend is somewhat greater in the case of a dividend of cash as compared to a dividend of stock under the conditions given below.

The following are the general formulae: for cash dividend $M^1 = M - C$; for stock dividend, $M^1 = M/1+S$. Where:

M = Per share market value immediately before the dividend is paid.

M = Per share market value ex dividend.

C = Per share cash dividend.

S = Per share stock dividend.

If C and S are evaluated on the issuer's books so as to set up the same per share charge to earned surplus, the value of S to the recipient is lower. Suppose that M = \$100; C = \$5; and S = 1/20 share, evaluated at \$5. Using the formulae given above, the results are

For cash dividend: \$100 − \$5 = \$95, which is market value ex cash dividend.

For stock dividend: \$100/(1+1/20) = \$95.24, which is market value ex stock dividend.

The per share market value ex dividend plus the dividend received is the same whether cash or stock dividend is paid, i.e.,

\$95 + \$5 cash = \$100

1.05 shares at \$95.24 per share = \$100

and the earned surplus is reduced identically in either case, i.e., by \$5 per share on stock outstanding, but the recipient of the cash dividend receives a larger amount than the recipient of the stock dividend, i.e., \$5 in cash as compared to \$4.76 in stock (\$95.24)/20.

from another stockholder or from the corporation is immaterial to the purchaser, disregarding for purposes of the point the fact that if purchased from the corporation it may be made at a preferential subscription price.

(2) The treatment of stock dividend received adopted in this study is applicable to any type of stock dividend. Dividends may be received in common stock on the same or a different class of stock; or in preferred stock on the same or a different class of stock. In the case of a stock dividend received on preferred stock, dilution of book value of the preferred stock on which the dividend is received is improbable, but if dilution does occur, application of test two will prevent overstatement of dividend income. Again, dividends received in the issuer's own stock may be of the small, periodic type or of the large, occasional type. A distinct advantage would thus appear in favor of the view advocated in the preceding pages in that the treatment suggested is generally applicable to any stock dividend received.

MEASUREMENT OF INCOME FROM STOCK DIVIDENDS

If the receipt of a stock dividend, under certain conditions, properly constitutes realized income, how is this income to be measured? The answer is found in the fair market value of the dividend stock. In fair market value exists a ready and authentic measure, which is the same as present or cash value[16]—a basis already noted as acceptable for the evaluation of other types of dividends not received in cash.[17]

A short example will aid in visualizing the position taken on the question under consideration. If a stockholder received a dividend of one-tenth of a share for each share held by him, the dividend so received would represent income to him as measured by the cash realizable value of the dividend, provided the dividend leaves the underlying investment unimpaired. The stockholder receiving the dividend has a certain number of shares carried in his books at cost (i.e., at cash value at time of purchase) and 10% of this number that is carried in the books at the cash value which prevailed at time of its receipt.

A limitation on this statement is the assumption that on the basis of test two described above the investment remains unimpaired upon the receipt of the stock dividend.

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[16] "Fair market value" is a recognized standard of reference in various accounting situations for a going business. Thus, a non-cash current asset such as raw materials inventory is usually priced for balance sheet presentation at cash realizable value (which is, in effect, fair market price at a particular date) if the cost of the inventory is in excess of market price.

Determination of fair market value of securities that are listed on public exchanges may offer practical difficulties in some cases (perfectly competitive market exists only in abstract theory), but it is believed that by and large the valuation problem is not insurmountable. A distinctly more difficult task is to determine fair market value of securities, other than those of close corporations, not listed on exchange or traded on an "over-the-counter" market. Until the 1936 Revenue Act was passed, stock dividend practice was confined, generally speaking, to the larger corporations—those listed on public exchanges. The undistributed profits tax provision of the Revenue Act of 1936 has probably considerably widened the range of corporations issuing stock dividends so as to include concerns whose securities do not have a readily ascertainable fair market value. Inactive securities of this type would have to be evaluated on a basis other than the price they would fetch, upon offer to sell, on an organized market. Bases helpful, under the circumstances alluded to, in solving the valuation problem include (a) prior cost of same security (b) average of such prior costs if holding was acquired by several purchases, and (c) book value of the security as disclosed by issuing company's latest balance sheet.

[17] Recalling that fair market value was advocated as the basis for capitalizing the dividend stock upon its issuance (see *supra*, Chapter VI), this measure justifies itself further as a sound basis because it treats the declaration of a stock dividend and its receipt as involving essentially the same problem, but viewed from two different sides. The decrease in earned surplus upon the paying corporation's books is exactly reflective of the increase of income on recipient's books. Two qualifications of this statement are, however, in order. (1) Dividends in non-cash assets and corporate obligations may lead to different treatment on recipient's books as compared to issuer's. (2) The application of test two, described on pages 257 ff. above, may cause a recipient to take up certain corporate distributions—stock dividends not excepted—at a lesser amount than that charged against earned surplus by distributor.

To illustrate the limitation referred to, suppose that the holding in the example stated consisted of ten common shares which cost $800 and was the sum of (1) capital stock $500 and earned surplus $100 and (2) market premium of $200. If the fair market value of the ten shares upon receipt of one dividend share of common stock is as great or greater than the sum of the three elements stated, the dividend share may be taken up as income at its fair market value under test two. In other words, the fair market value of the ten shares upon receipt of the dividend share must not only amount at least to $800, but this minimum value must include a book value of at least $600 (sum of capital stock and earned surplus at acquisition). Thus, if the value of the original ten shares amounted to $800 immediately after the receipt of one dividend share, and the $800 is ascertained to represent $590 of book equity and $210 of market equity, the income taken up on the one dividend share would be $70. The books of the stockholder would show total ledger value of $870 for eleven shares of stock with a market value of $880 (80×11):

10 shares of original stock, carried at $80 per share	$800
1 share of dividend stock	70
11 shares—total ledger value	$870

If, subsequently, all or any portion of the dividend stock is sold a further gain or loss may occur, depending upon the difference between the per-share ledger value of the dividend stock and the price received per share, multiplied by the number of shares sold. The difference between "cost" so arrived at and sales price may or may not be in accord with calculations under an income-tax law, the point at issue there being interpretation of some current tax regulation.

COMPARISON WITH PRESENT PRACTICE UNDER FEDERAL INCOME TAXATION

Aside from certain questions involving distinction between cash and stock dividends, the test used to determine whether a particular stock dividend is income subject to taxation is whether or not there has occurred an "alteration of interest" for the recipient in the corporation. This test appears logical in that the occurrence of a change in a stockholder's interest, through the receipt of a stock dividend, may materially alter his status with respect to the investment in question. And the time of such a change, on the principle of an actual and closed transaction, may be appropriate for inquiry as to a gain to the recipient stockholder for taxation purposes. The method of measuring the gain is, however, entirely arbitrary, and for this reason is objectionable. As already noted, the amount of gain subject to tax from the receipt of a taxable stock dividend is the fair market value of the dividend stock. A test of impairment of the investment, as measured by acquisition cost, on which the dividend is received is thus lacking.

There is close resemblance between the present study and practice under federal income taxation in the conclusion as to nature of a stock dividend received, though it is believed that the reasoning behind the conclusion is not parallel all the way. The discussions here have suggested what the more important of the differences are. It suffices to say that both are in agreement that income must be realized. The requirement of realization under income taxation turns on whether or not the receipt of a stock dividend produces a "different interest" for the stockholder. The present study, on the other hand, views as realized income any stock dividend that is received.

For the measurement of income from a stock dividend, a material difference exists between the treatment advocated in this

study and that followed under income taxation. This study suggests a method by which impairment of underlying investment may be avoided in determining the amount of stock dividends to take up as income. Under the federal-income-tax law, this feature is absent.

COMPARISON WITH LAW IN TRUST DISTRIBUTIONS

The laws of the various states are not uniform on the question. Individual state laws broadly fall into three classifications. Under the "Massachusetts rule," stock dividends do not constitute income upon receipt by an estate or trust. Under the "Kentucky rule" stock dividends declared from earned surplus are considered income to the recipient. The "Pennsylvania rule" provides for the apportionment of stock dividends received between principal and income. Briefly stated, a stock dividend is income under this rule to the extent that the book equity of the stock on which the dividend is received is not impaired. The book equity to be kept unimpaired is that in existence at a particular base date, such as the date at which the stock in question was inventoried as part of corpus.

A close resemblance may be observed between the treatment of stock dividends received by an estate or trust under the "Pennsylvania rule" and the treatment suggested in this study. The effect of both methods is to permit the recipient to take up income earned on the investment from some base date.

COMPARISON WITH PRESENT PROVISION OF PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

The present Uniform System of Accounts for public utility holding companies permits these companies to treat stock dividends received substantially as advocated in the present study.[18] The differences are: (a) in the case of stock dividends received from subsidiaries, the amount of income taken up cannot exceed the charge to earned surplus on the subsidiary's books; (b) in the case of stock dividends received from investment in other companies, the amount of income taken up cannot exceed the charge to earned surplus by the distributor or the market value of the dividend, whichever is less.

The taking up of income by parent companies from subsidiaries when and as received in dividends, instead of when and as earned by the subsidiaries, amounts to the interposition of the subsidiary corporation as a separate legal entity. In this respect, there is a departure from the view adopted in the present study that for a close corporation the legal entity should be disregarded for the purpose of determining the income of the parent corporation. But since consolidated financial statements are prepared and published in practically every instance, the final showing does not really matter, from the standpoint of the consolidated results. Whether the parent corporation takes up income when and as earned by its subsidiaries or only when and as duly received as dividends, the consolidated statements will be the same.

[18] The text of the instruction is as follows: "At the option of the company, a dividend received in stock of a paying company may be included in income . . . to the extent that such dividend is declared from earnings subsequent to acquisition by the company of the stock in respect of which the dividend is paid; provided, however, that such dividend shall not be included in income . . . at a greater amount than charged by the paying company to its income and/or earned surplus . . . and provided further, that if the stock dividend is received on stock of a company not included in the consolidated accounts . . . [statements?] of the receiving company and such stock is dealt in on any exchange or market, the amount included in income . . . for such dividend shall not be greater than the amount charged by the paying company to its income and/or earned surplus . . . or the market value of the stock received, whichever is less . . . " *Uniform System of Accounts for Public Utility Holding Companies* (1936), United States Securities and Exchange Commission, Washington, D. C. p. 25.

COMPARISON WITH "ORTHODOX" ACCOUNTING VIEW

Under the so-called orthodox accounting view, a stock dividend is not income upon receipt.[19] The orthodox view has, however, in recent years received only mild support from public accountants. Thus, a special committee of the American Institute of Accountants declared in 1932: "Stock Dividends if credited to income should be shown separately with a statement of the basis upon which the credit is computed."[20] Substantially the same position is taken by the Institute in a more recent publication where it is stated that "If stock dividends received have been included as income, that fact as well as the basis on which they have been taken up should be indicated."[21] These pronouncements may be interpreted as indicating the Institute's disapproval of treatment of stock dividends received as income. There is a plain hint, and tacit recognition, however, that the taking up of stock dividends received as income may be justified under certain circumstances.

Lack of unanimity among public accountants as to the treatment of stock dividends received is illustrated by the variety of answers given to each of 4 cases. Both questions and answers are summarized below and on the following page. The answers were in response to a recent request made by the bureau of information, a department of the *Journal of Accountancy*, official publication of the American Institute of Accountants.[22] Unless specific reference is made to income-tax status, the answers refer to proper accounting treatment on the books of the recipient independent of calculations under tax law. Qualifications were made, however, by the writers of the answers as to applicability of answers under "all circumstances." All three answers to each case stressed necessity of review by legal counsel in specific tax situations, presumably to guard against income-tax liability or excessive payment of income tax.

[19] See, e.g., Montgomery, R. H., *Auditing Theory and Practice* (1934), p. 496; Paton, W. A. (Editor), *Accountants Handbook* (1932), p. 329; Hatfield, H. R., *Accounting* (1927), p. 212; Finney, H. A., *Principles of Accounting*, Volume 1 (1934), p. 121; Kester, R. B., *Advanced Accounting* (1933), p. 506; Himmelblau, D., *Complete Accounting Course*, Volume II (1934), p. 181; and *Editorial* (1935) 59 *Journal of Accountancy* 13. Accounting literature is not without statements of doubt as to the logical soundness of the "orthodox view." In this connection, see, e.g., Hatfield, H. R., *op. cit.*, p. 212; and Husband, O. R., and Thomas, O. E., *Principles of Accounting* (1935), p. 419.

[20] Letter addressed to the New York Stock Exchange under date of September 22, 1932. See *Audit of Corporate Accounts* (1934), p. 18, a pamphlet published by the American Institute of Accountants, New York.

[21] *Examination of Financial Statements* (1936), p. 32.

[22] (1937) 64, *Journal of Accountancy*, 455.

ACCOUNTING TREATMENT

	Answer 1	*Answer 2*	*Answer 3*
Case 1 A dividend on common stock of 50 cents per share in cash or in 1/200 of a share of $100 par value preferred stock.	(a) take up cash as income; or (b) take up pref. stock at amount of cash option waived.	(a) take up cash as income; (b) refer to income tax status.	(a) take up cash as income or (b) take up pref. stock at amount of cash option waived, provided such amount is not above current market price of stock. However, taxable income is market value of the shares received.
Case 2 A dividend on common stock 3/100 of a share of $100 par value preferred stock.	Take up pref. stock at market value.	Refer to income tax status.	Take up pref. stock at lower of (1) market price on day of receipt of dividend, or (2) per share charge to surplus by issuer. However, taxable income is market value of the shares received.

Case 3 A dividend on common stock of $2 per share in preferred stock of $100 par value.	*Answer 1* The stockholder has nothing he did not formerly possess; no income to take up.	*Answer 2* Refer to income tax status.	*Answer 3* Answer same as in first paragraph in case 2 above. No taxable income because no pref. stock was previously outstanding.
Case 4 A dividend on common stock of $1 per share in cash or in common stock at a price below present market value.	(a) take up cash as income; or (b) take up com. stock at amount of cash waived.	(a) take up cash as income; (b) refer to income tax status.	(a) take up cash as income; or (b) same as answer to question (1), part (b).

COMPARISON WITH INVESTMENT TRUST PRACTICE

Investment trusts, whose principal body of assets consists of securities, have been confronted with the problem of stock dividends in a highly practical form with the spread of the practice of paying dividends in capital stock instead of cash. With respect to small, periodic stock dividends, a variety of methods have been adopted with no apparent objection from professional accountants, judging from "clean" auditor's certificates and lack of statement footnotes.[23]

A not uncommon practice before the New York Stock Exchange Regulations of 1929 and 1930 (discussed below) was to take up periodic stock dividends received as income on the basis of current market price or ex-dividend market price.[24] Since the Exchange Regulations referred to, listed companies have adhered to this regulation, which is discussed below.

An examination of the 1936 annual reports of nineteen investment trusts, including some of the larger companies in this field, disclosed that seven of the companies in the sample reported stock dividends (mostly in "taxable dividend stock") as income but generally gave no indication of the price at which they were taken up as income.[25] Some companies take up all stock dividends as income if the dividend shares do not exceed 10% of

[23] "Current practice varies all the way from the policy of ignoring stock dividends in their entirety in the income account of receiving companies, to the policy of taking them into the income account . . . at the full market value on the date received." Announcement on Stock Dividends, dated September 11, 1929, by New York Stock Exchange.

Before the passage of the Securities Act of 1933 and the Securities and Exchange Act of 1934, the majority of investment companies failed to disclose the basis, if any, upon which stock dividends received were taken into income. This fact is attested to by the results of a study of the 1929 annual reports of 80 unlisted investment trusts. It was found that 70 of the 80 companies "failed to note the method of including stock dividends in income." See McMartin, J. S., "Reporting Investment Trust Income" (1931), 9, *Harvard Business Review*, 497.

[24] See preceding note. For an example see *infra* note 45. Unlisted companies were of course unaffected by the stock exchange regulations.

[25] For an example of a report in which the valuation basis is given, however, see, Lehman Corporation report for year ended June 30, 1937. From p. 8 of this report: "Dividends . . . in securities which are taxable have been taken into income . . . at . . . market value on date of receipt . . . [provided such amounts] were not in excess of the amounts charged to surplus by the paying corporations."

The investment trusts which showed stock dividends received as income were: Atlas Corporation; General American Investors Co., Inc.; Lehman Corporation; Prudential Investors, Inc.; State Street Investment Corporation; Fundamental Investors, Inc.; Affiliated Fund, Inc.

The investment trusts which failed to disclose whether or not dividend income included stock dividends received were: Adams Express Co.; Blue Ridge Corporation; Equity Corporation; General Public Service Corporation; Solvay American Investment Corporation; and United States and Foreign Securities Corporation.

The investment trusts which expressly restricted dividend income to cash dividends were: Selected American Shares, Inc.; First Investment Council Corporation; Chicago Corporation; National Bond and Share Co.; North American Investment Corporation; and Tri-Continental Corporation. The following interesting foot note to the dividend income section appeared in the 1936 profits statement of Tri-Continental Corporation: "Includes all cash received or receivable . . . whether payable from earnings or otherwise, except amounts expressly stated to be liquidating distributions. In an economic sense, therefore, the amount shown is not in whole to be considered true income." See p. 10 of 1936 annual report of company.

the shares on which the dividend was declared.[26]

Certain investment trusts (so-called fixed type) are required by their charters to sell stock dividends received and to treat proceeds as income.[27]

COMPARISON WITH REGULATIONS OF NEW YORK STOCK EXCHANGE

The position of the Stock Exchange is that a listed company may take up stock dividends received as income, provided the amount of income so taken up does not exceed the charge to earned surplus in respect of the issuance of the dividend stock on the payor's books.[28] This view is in agreement with the conclusions here: (1) if the distributor used the market-value standard for the charge against its earned surplus, and (2) if the recipient's investment after receipt of the dividend is left unimpaired according to the test suggested.

Example Comparing Three Views

The differences between the so-called orthodox accounting view, the New York Stock Exchange view, and that of the present study, are illustrated by the example given below. The conditions assumed in the example are:

1. A corporation's balance sheet shows, as of January 1, 1937, a per share book equity of its common stock as follows: capital stock and paid-in surplus, $80; earned surplus $10.
2. 1937 earnings amount to $12 per share.
3. At year-end, a dividend of one-twentieth of a common share is declared on each share outstanding.
4. An individual purchased at the beginning of 1937 20 shares of the stock of the foregoing corporation at a price of $98 per share.
5. The corporation is a member of the New York Stock Exchange and chooses to follow the minimum standard laid down by the Exchange and so capitalizes the dividend stock at $80 per share.
6. Fair market value of dividend share when received is $101.
7. The dividend stock is sold at a later date for $107.
8. The ten original shares are subsequently sold at $104 per share.

[26] In an interview in September, 1937, with an officer of Calvin Bullock, Inc., New York investment trust managers, the writer was advised that the policy recommended by them was to take up all stock dividends received as income at market value at date of receipt, "if the dividend stock did not exceed 10%." Stock dividends "in excess of 10%" are presumably recorded only by memorandum entry in the investment account showing receipt of the *number* of dividend shares with no dollar extension in the money column. How prevalent the foregoing practice was among investment trusts generally at that time was not ascertained. The 10% division line is used by the Massachusetts Investors Trust, a large company organized in 1924, and with assets in excess of $110,000,000 (as per balance sheet at September 30, 1937). From p. 10 of prospectus dated December 15, 1937: "The Trustees have discretion to determine which items shall be treated as earnings and which as principal, but they must treat as principal stock dividends received, except when companies have established the practice of paying stock dividends not exceeding ten per cent (10%) per annum in lieu of or in addition to cash dividends, in which cases the Trustees may in their discretion treat such stock dividends as earnings."

[27] For a comprehensive survey of practice among fixed investment trusts on the point, see Durst, W. N., *Analysis and Handbook of Investment Trusts* (1932), pp. 301–366.

[28] Special Announcement on Stock Dividends, dated April 30, 1930. The text of the announcement is as follows: "The Exchange will not knowingly list any of the securities of a corporation which takes up as income upon its books stock dividends received at a larger figure than the proportionate amount charged against . . . earned surplus by the issuing company."

	(A) Orthodox Accounting View	(B) New York Stock Exchange View	(C) View Proposed in This Study
(a) Cost of acquiring 20 shares at $98 per share	$1,960.00	$1,960.00	$1,960.00
(b) Income upon receipt of one dividend share	—	80.00	101.00
(c) Resulting investment in 21 shares	$1,960.00	$2,040.00	$2,061.00
(d) Ledger value of dividend share:[29]			
(1) 1/21 of $1,960.00	$ 93.33	—	—
(2)	—	$ 80.00	—
(3)	—	—	$ 101.00
(e) Sale of dividend share for	107.00	107.00	107.00
(f) Profit on sale of dividend share	$ 13.67	$ 27.00	$ 6.00
(g) Income originally taken up when stock dividend was received (b)	—	80.00	101.00
(h) Total income arising out of receipt and sale of one dividend share	$ 13.67	$ 107.00	$ 107.00
(i) Ledger value of original stock	$1,866.67	$1,960.00	$1,960.00
(j) Sale of original stock for	2,080.00	2,080.00	2,080.00
(k) Profit on sale of original stock	$ 213.33	$ 120.00	$ 120.00
(l) Profit previously taken up: (f)	13.67	—	—
(f) plus (b)	—	107.00	107.00
(m) Total profit upon disposition of holding, including dividend share received	$ 227.00	$ 227.00	$ 227.00

[29] It is advisable to average the carrying value of the stock under the orthodox method, but not under the other two. Under the other two methods, the calculation proceeds on the theory that the stock certificate representing the dividend share is income (measured according to the standard adopted), and is subject to further gain or loss in the event of a subsequent sale. The original 20 shares are accounted for separately in accordance with their own ledger value. Thus, if the first share sold was not the dividend share, a profit of $9 would be shown under methods A and B. This amount plus $101 taken up at date of receipt of dividend share results in a profit of $110 as of date of first sale, and leaves a total investment of $1963 ($1960−$98+$101) upon which a profit of $110 is made on final disposal at $104 per share.

SURPLUS ADJUSTMENTS IN THE IRON AND STEEL INDUSTRY

Frank P. Smith

The past decade has witnessed a new emphasis on accounting principles and practices. This added emphasis has resulted in a critical re-analysis of our principles, and a revaluation of many of our practices. Of the many factors which contributed to bring about this change, two seem basic: (1) changing price levels and (2) technological changes. The first raises, in a new light, the problems of valuation; the second raises the problem of writing off assets which are physically usable but economically useless. Both of these factors, obviously, operate to qualify profit and loss statements and balance sheets.

The problems arising from the necessity of preparing annual statements, during periods of fluctuating price levels and important technological changes, have been pointed out by many writers. The frequent adjustments to surplus which result, at least in part, from this practice have received attention. Studies in both fields have been supplemented by case studies of individual companies.[1]

[1] For data bearing specifically on iron and steel companies, see Owens, Richard N., "Surplus Accounts of

The purpose of this paper is to attempt to measure, as far as possible, the surplus adjustments made by an industry over a twenty-one year period, 1915–35. The iron and steel industry was chosen for three reasons: (1) a relatively small number of companies comprise the major part of the industry, and consequently, the work of collecting data is reduced to manageable proportions; (2) this industry had reached maturity by 1915, when this study begins; (3) this industry has undergone rapid technological changes during this period which have rendered obsolete much physically useful equipment.[2]

The period 1915–35 was selected because of availability of data for individual companies. Very little financial information is available for individual concerns in this industry, prior to 1914, and data for only 13 companies are included for the first four years. For the years 1919–23, data are included for 19 companies, for the period 1924–28, for 28 companies, and for the period 1929–35, for 37 companies.

In selecting companies, an attempt was made to include all of the leading companies in the iron and steel industry, and to include as many as possible of the smaller companies having assets in excess of two million dollars each.

PROCEDURE

The procedure followed throughout this study was adopted in order to emphasize changes in surplus for the industry,[3] although data were first accumulated for individual companies, by years. The data were taken from consolidated financial statements as reported in Poor's and Moody's Manuals, supplemented, wherever possible, by the published annual reports of individual companies. Included for each company are (1) year-end figures for all surplus accounts, (2) stock dividends declared, and (3) profits or deficits transferred to surplus after providing for dividends declared and payable other than in the company's own securities.

The amounts of profits or deficits carried to surplus (after cash dividends), were then compared with the net change which actually occurred in the surplus accounts —all stock dividends declared were written back to surplus. The differences between profits to surplus, and surplus changes, after eliminating all dividends, were then determined for each company and related to net profits or deficits transferred to surplus.

The differences between surplus changes and profits to surplus, as determined above, are not a result of the profits or deficits carried to surplus. Such changes, which are not accounted for by profits or deficits to surplus, however, do qualify reported profits or losses. These changes might be related to total profits or losses before fixed charges, before cash dividends, or as was done in this study, to profits or losses carried to surplus after fixed charges and cash dividends.

The method outlined has the effect of placing the full burden of the adjustments on the corporate entity. It is immaterial whether dividends are deducted from net profits available for dividends, as was done, or are deducted from surplus and the entire amount of profits available for dividends then added—the method adopted was selected for the sake of convenience. The important point is that in all cases studied cash dividends were eliminated since they were paid in current dollars. That surplus adjustments in the same or following years may signify that dividends

Iron and Steel Companies," ACCOUNTING REVIEW, June 1936.

[2] See Hosmer, W. A., "The Effect of Direct Charges to Surplus on the Measurement of Income," ACCOUNTING REVIEW, March, 1938, pp. 31–33.

[3] The ten largest of the companies studied represented approximately 75% of the total ingot capacity of the United States for the first two periods, and 80% for the remaining periods studied. The eighteen largest companies represented 86% of total ingot capacity, as of 1935.

were earned by larger or smaller margins than the income reports indicated places the burden of net surplus adjustments on the corporation. The stockholders are affected in the sense that such adjustments may have an important bearing on future profits and dividends. This means that, in the long run, the real importance of surplus adjustments is in the relationship of such adjustments to retained profits.[4]

The final step in assembling this information was to classify the companies into size groups, and to arrange the data by periods of years. The companies were classified by size in order to compare the results, by periods, for the large, medium, and small-sized companies. The aggregates of current assets plus gross plant was the basis of classification used—selected as most closely approximating the parts of total consolidated assets used in the iron and steel industry. In order to simplify the treatment, the information was arranged into four periods, 1915–23, 1924–28, 1929–35, and the companies were classified into size groups as of the years 1918, 1919, 1924, 1929.

TABLE I

NET SURPLUS CHANGES FOR SELECTED COMPANIES, 1915–18
(000's omitted)

Classification of companies[a]	*Number of cos. studied*	*Profits to Surplus*[b] *\$ Col. 1*	*Increases in Total Surplus*[c] *\$ Col. 2*	*Net Surplus Adjustments*[d] *\$ Col. 3*	*Per cent Col. 3 is of Col. 1 Col. 4*
I. U. S. Steel[e]	1	394,751	331,384	− 63,367	16%
II. $500–100,000,000	4*	146,588	102,434	− 44,154	30%
III. $99–20,000,000	5**	49,554	52,575	3,021	6%
IV. Less than $20,000,000	3***	3,210	2,868	− 342	11%
Net Totals	13	594,103	489,261	−104,842	18%
Aggregate Change[f]				110,884	19%

[a] Companies are classified according to gross plant plus current assets as of 1918.
[b] After cash dividends.
[c] Adjusted for stock dividends.
[d] Decreases are shown −.
[e] It has seemed desirable to treat the United States Steel Corporation separately in these tables because of its size.
* Bethlehem Steel, Colorado Fuel & Iron, Republic Steel, Crucible Steel.
** Pittsburgh Steel, Sloss-Sheffield Steel & Iron, Inland Steel, American Rolling Mill, Gulf States Steel.
*** Stanley Works, Atlantic Steel, Keystone Steel & Wire.
[f] The sum of net surplus adjustments related to total profits to surplus (Col. 1).

SURPLUS CHANGES, 1915–18

Profits[5] in the iron and steel industry were high during this four-year period, and the companies studied were expanding their gross plants and increasing their current assets.[6] Yet, even in this prosperous period, iron and steel companies were experiencing large debit adjustments to surplus. Table I indicates the profits carried to surplus, net surplus changes, and differences between these two aggregates, for the thirteen companies for which data are available.

Net debit surplus adjustments were important for three of these four groups of companies, although for each of the four groups profits exceeded cash dividends, leaving net profit to be carried to surplus. Substantial stock dividends were paid out

[4] For a discussion of the use of retained profits, see Van Arsdell, Paul M., "Problems of Corporate Surplus Administration," ACCOUNTING REVIEW, September, 1938.

[5] Total profit available for dividends, for the years 1915–18, represented the following percentages of total gross plant plus current assets, 7%, 21%, 13%, 8%.

[6] Using 1914 as a base, the percentage increases in aggregate gross plant, for the years 1915–18, were as follows: 12%, 21%, 32%, 39%; and for current assets, 33%, 91%, 314%, 243%.

TABLE II

NET SURPLUS CHANGES FOR SELECTED COMPANIES, 1919–23
(000's omitted)

Classification of companies[a]	Number of cos. studied	Profits to Surplus[b] $ Col. 1	Increases in Total Surplus[c] $ Col. 2	Net Surplus Adjustments[d] $ Col. 3	Per cent Col. 3 is of Col. 1 Col. 4
I. U. S. Steel	1	114,480	45,863	− 68,617	60%
II. $500–100,000,000	3*	29,322	9,211	− 20,111	69%
III. $99–20,000,000	9**	5,439	15,708	10,269	89%
IV. Less than $20,000,000	6***	6,406	5,026	− 1,380	22%
Net Totals	19	155,647	75,808	− 79,839	51%
Aggregate Change				−100,377	64%

[a] Companies are classified as of 1919.
[b] After cash dividends.
[c] Adjusted for stock dividends.
[d] Decreases are shown −.
* Bethlehem Steel, Crucible Steel, Republic Steel.
** Colorado Fuel & Iron, Inland Steel, Cleveland-Cliffs Iron, Pittsburgh Steel, American Rolling Mill, Sloss-Sheffield Steel & Iron, United States Case Iron Pipe, Otis Steel, Gulf States Steel.
*** Keystone Steel & Wire, Superior Steel, Stanley Works, Scullin Steel, Atlantic Steel, Ludlum Steel.

in this period but the surplus figures shown have been corrected for such dividends and they need not be considered here.

The net surplus adjustments (Column 3), are compared to net profits carried to surplus (Column 1), and percentages are computed as if the net adjustments were all positive (Column 4). Column 3 indicates whether the net adjustments to surplus are debit or credit and Column 4 should be interpreted according to the nature of the adjustment as shown in Column 3. For example, the United States Steel Corporation transferred $395,000,000 of profits to surplus, but the total surplus of this company increased by only 84% of this amount. Debit adjustments thus exceeded credit adjustments by $63,000,000 and the estimate of retained profits would seem to have been too high by 16%. The surplus of conpanies in Group III, on the other hand, increased by 106% of the amount of profits transferred to surplus, indicating net credit adjustments.

SURPLUS CHANGES, 1919–23

The iron and steel companies, in the period 1919–23, recorded a steady increase in gross plant,[7] but profits[8] available for dividends were small, and the results of the liquidation movement experienced in this period were evident in the current assets.[9]

Table II indicates, for each group of companies, profits transferred to surplus, surplus changes which occurred, and net surplus adjustments.

All surplus changes for this period represented increases and each of the four groups of companies transferred profits to surplus. However, the increases in surplus were not equal to the profits transferred to surplus for three of the four groups of companies. Companies in Group III alone reported surplus changes which exceeded the profits carried to surplus.

When the net surplus adjustments (Column 3) are related to profits carried to surplus (Column 1), the resulting percentages (Column 4) indicate the need for important qualifications of the reported profits which were carried to surplus. The extent to which such qualifications are necessary varies with the different groups but is important for all of them.

[7] With 1919 as the base year, gross plant increased, for the years 1920–23, as follows: 5%, 9%, 12%, 21%.
[8] Profits available for dividends, for the years 1919–23, represented the following percentages of gross plant plus current assets, 5.4%, 5.6%, 0.0%, 2.5%, 6.5%.
[9] Current assets, for the years 1920–23, compared with the base year, 1919, as follows: 103%, 84%, 79%, 93%.

TABLE III

NET SURPLUS CHANGES FOR SELECTED COMPANIES, 1924–28
(000's omitted)

Classification of companies[a]	*Number of cos. studied*	*Profits to Surplus*[b] $ *Col. 1*	*Increases in Total Surplus*[c] $ *Col. 2*	*Net Surplus Adjustments*[d] $ *Col. 3*	*Per cent Col. 3 is of Col. 1* *Col. 4*
I. U. S. Steel	1	161,937	100,847	− 61,090	38%
II. $800–100,000,000	6*	113,418	45,634	− 67,784	60%
III. $99–20,000,000	10**	54,102	73,692	19,590	36%
IV. Less than $20,000,000	11***	18,463	21,464	3,001	16%
Net Totals	28	347,920	241,637	−106,283	31%
Aggregate Change				151,465	44%

[a] Companies are classified as of 1924.
[b] After cash dividends.
[c] Adjusted for stock dividends.
[d] Decreases are shown −.
* Bethlehem Steel, Youngstown Sheet & Tube, Jones & Laughlin Steel, Crucible Steel, Republic Steel, Wheeling Steel.
** Colorado Fuel & Iron, Inland Steel, American Rolling Mill, Cleveland-Cliffs Iron, Pittsburgh Steel, United States Cast Iron Pipe, Sloss-Sheffield Steel & Iron, Otis Steel, Gulf States Steel, Sharon Steel Hoop.
*** Stanley Works, Follansbee Bros., A. M. Byers, Keystone Steel & Wire, Scullin Steel, Superior Steel, Acme Steel, Laclede Steel, Eastern Rolling Mill, Atlantic Steel, Ludlum Steel.

In reading these tables, it must be remembered that the data shown in Tables I and II and following are not presented as indicating trends. Each period should be considered by itself because of the fact that identical companies are not included in all of the tables. As many companies as possible have been included and the number for which data are available increases with each succeeding table. Moreover, not all of the companies remain in the same group classification in all of the tables.

The only data included which can be considered as indicating a trend, are the data for United States Steel. The net debit surplus adjustments in the period 1919–23, although only slightly larger in absolute amount, were much more important in relation to retained profits than for the period 1915–18.

For the combined companies, only 49% of retained earnings resulted in increased surplus. Net debit adjustments to surplus accounted for the balance, or 51% of retained profits.

SURPLUS CHANGES, 1924–28

The period 1924–28 was characterized by continuous but small additions to gross plant,[10] some slight changes in current assets,[11] and regular but small reported profits[12] available for dividends.

Table III indicates, for each group of companies, profits transferred to surplus, surplus changes, and net surplus adjustments.

In this period, all companies transferred profits to surplus and reported increases in total surplus. For United States Steel, and companies in Group II, the increases in surplus were much less than the aggregate profits added to surplus. The companies in Group II, in particular, suffered net debit adjustments equal to 60% of the total profits carried to surplus. Contrasted with these results are the important net credit adjustments recorded by companies in Groups III and IV. The net surplus adjustments were important for all of the groups studied and seriously qualified the estimates of reported profits retained by these companies.

[10] Using 1924 as the base, the aggregate gross plant figures for 1925–28 increased by the following percentages, 4%, 6%, 10%, 13%.

[11] Percentages for the years 1925–28, with 1924 as the base were as follows: 101%,106%, 100%, 107%.

[12] Profits available for dividends in the years 1924–28 represented the following percentages of gross plant plus current assets: 4.4%, 5.4%, 6.0%, 5.6%, 5.4%.

SURPLUS CHANGES, 1929–35

During this period gross plant[13] first increased sharply, 1929–30, then increased by small amounts. Current assets[14] decreased to a low point in 1932, then increased through 1935. Profits[15] were low and surplus balances were reduced.

Table IV indicates, for each group of companies, profits transferred to surplus, surplus changes, and net surplus adjustments.

each group are, relatively, very large as compared to the decreases which might be expected as resulting from dividends and operating losses. Two main factors accounted for these large adjustments, reductions in the carrying value of assets, and reorganizations of financial structures.

The net adjustments in this period are so large, relative to earnings and deficits, that any analysis based on earnings or losses per share, or earnings retained, is almost meaningless.

TABLE IV

NET SURPLUS CHANGES FOR SELECTED COMPANIES, 1929–35
(000's omitted)

Classification of companies[a]	Number of cos. studied	Profits to Surplus[b] $ Col. 1	Increases in Total Surplus[c] $ Col. 2	Net Surplus Adjustments[d] $ Col. 3	Per cent Col. 3 is of Col. 1 Col. 4
I. U. S. Steel	1	− 92,337	−157,760	− 65,423	71%
II. $1,000–100,000,000	9*	− 44,476	82,539	127,015	286%
III. $99–20,000,000	13**	− 20,372	− 36,873	− 16,501	81%
IV. Less than $20,000,000	14***	− 7,192	2,142	9,334	130%
Net Totals	37	−164,377	−109,952	54,425	33%
Aggregate Change				218,273	133%

[a] Companies are classified as of 1929.
[b] After cash dividends. Deficits are show−.
[c] Adjusted for stock dividends.
[d] Decreases are shown−.
* Bethlehem Steel, Youngstown Sheet & Tube, Jones & Laughlin Steel, Crucible Steel, Republic Iron & Steel, Wheeling Steel, National Steel, American Rolling Mill, Inland Steel.
** Cleveland-Cliffs Iron, Pittsburgh Steel, Otis Steel, United States Pipe & Foundry, Sloss-Sheffield Steel, Spang-Chalfont, Gulf States Steel, Sharon Steel, Alan Wood Steel, Allegheny Steel, A. M. Beyers, McKeesport Tin Plate, Stanley Works.
*** Granite City Steel, Continental Steel, Follansbee Bros., Keystone Steel & Wire, Acme Steel, Carpenter Steel, Ludlum Steel, Scullin Steel, Laclede Steel, Eastern Rolling Mill, Superior Steel, Atlantic Steel, Apollo Steel, Milton Manufacturing.

In this period none of the groups of companies reported sufficient profits to cover dividends declared, although Groups II and IV reported increases in surplus. The surplus balances for United States Steel and companies in Group III, however, decreased by more than the aggregate deficits transferred to surplus after dividends. The net surplus adjustments for

[13] Using 1929 as the base, the percentages of aggregate gross plant, for the years 1930–35, were as follows: 112%, 115%, 115%, 114%, 115%, 117%.

[14] The relatives for the years 1930–35, with 1929 as the base, were as follows: 92%, 78%, 64%, 66%, 69%, 77%.

[15] Net profits or deficits before dividends, for the years 1929–35, represented the following percentages of gross plant plus current assets: 7.0%, 3.4%, −1.5% −3.2%, −.8%, .8%, 2.4%.

RELATIONSHIP OF NET SURPLUS CHANGES TO PROFITS AVAILABLE FOR DIVIDENDS, 1915–35

In the first three tables the data for surplus changes have been related to that part of reported profits which has been retained by the companies studied. In Table IV the net surplus adjustments have been related to the deficits remaining after declared dividends have been subtracted from profits, or added to losses.

Surplus adjustments, obviously, affect all reported profits and losses. Net surplus adjustments may indicate that the estimates of profits or losses were unduly high

or low and, thereby, may indicate that analyses based on annual income statements were faulty to the extent that the surplus adjustments correct for past errors of judgment. Analyses of corporate profits are customarily stated in terms of earnings per share available for dividends. Table V expresses net surplus adjustments as percentages of profits available for dividends, by periods.

TABLE V

NET SURPLUS ADJUSTMENTS EXPRESSED AS PERCENTAGES OF TOTAL PROFITS AVAILABLE FOR DIVIDENDS, BY PERIODS

	1915–18	*1919–23*	*1924–28*	*1929–35*
Number of companies studied	13	19	28	37
Classification of companies[a]				
I	9%	18%	12%	35%
II	22%	20%	27%	95%
III	4%	21%	16%	39%
IV	5%	9%	8%	70%
Net Totals	11%	15%	12%	14%
Aggregate changes	11%	19%	17%	58%

[a] See Tables I–IV.

Although these data are shown in a single table, different companies are represented in the various periods, and the data are not presented as indicating trends.

The percentages shown in Table V are, of course, much smaller than those shown in Tables I–IV. However, net surplus adjustments represent important qualifications of profits for these periods, even when spread over the total profits available for dividends.

SURPLUS CHANGES OF INDIVIDUAL COMPANIES

With the one exception of United States Steel, all the data presented have been arranged by companies according to size and by periods. Data are available for the majority of companies studied for sufficiently long periods of years to permit a showing of the surplus changes of individual companies. This showing includes the corrections resulting from several violent fluctuations in price levels. Table VI indicates, by companies, profits or losses to surplus, increases in surplus, and net surplus adjustments.

Table VI represents some interesting variations in results as between different companies, but it is difficult to discover any pattern in the net surplus adjustments. Ten of the thirty-seven companies carried net deficits to surplus (after dividends) and only three companies reported net decreases in surplus totals. In many cases, however, surplus balances did not change by the amount of profits and deficits transferred to surplus, as is indicated in Column 3. The net surplus adjustments (Col. 3), expressed as percentages of profits or deficits to surplus (Col. 1), are shown in Column 4. This method, as has been pointed out, places the burden of debit adjustments on that part of earnings retained by the companies and the percentages are, of course, much higher than would be the case if the figures in Column 3 were expressed as percentages of net profits available as dividends.

With only a few exceptions, the percentages shown in Column 4 are high, indicating that substantial qualifications need to be made with respect to retained earnings. Approximately 80% of the companies in this group recorded net surplus adjustments of 11% or more of profits to surplus; approximately 40% reported adjustments of 100% or more; approximately 30% reported adjustments of 200% or more of profits to surplus.

There seems to be little relationship between the percentages shown in Column 4 and either the size or age of the companies. The larger percentages seem to occur more frequently in the extremely large and very small companies than in the middle group, but the case is not clear.

The net changes in surplus reserves which occurred during the periods for which data are available for each com-

TABLE VI

NET SURPLUS CHANGES OF INDIVIDUAL COMPANIES, 1915–35
(000's omitted)

Company[a]	*Number of years studied*	*Profits to Surplus*[b] $ *Col. 1*	*Increase*[c] *in Total Surplus*[d] $ *Col. 2*	*Net Surplus Adjustments*[d] $ *Col. 3*	*Per Cent Col. 3 is of Col. 1* *Col. 4*	*Increase in Reserves*[e] $ *Col. 5*
United States	21	578,831	320,334	-258,497	45	-16,790
Bethlehem	21	115,437	120,428	13,009	11	-17,314
Republic	21	10,313	53,368	43,055	417	10,377
Youngstown	14	21,048	-27,929	- 48,977	233	229
National	6	29,379	26,481	- 2,898	10	1,993
Jones & Laughlin	12	19,516	17,669	- 1,847	9	- 1,634
Inland	21	54,819	36,991	- 17,828	33	3,695
Wheeling	15	- 900	1,491	2,391	266	- 3,287
Am. Roll. Mill	21	8,275	26,057	17,782	215	993
Crucible	21	41,110	37,873	- 3,237	8	4,915
Cleveland-Cliffs	17	5,895	12,487	6,592	112	1,427
Pittsburgh	21	7,412	9,221	1,809	24	693
Otis	16	2,617	99	- 2,518	96	910
U. S. Pipe & Fdry.	20	12,704	8,312	- 4,392	35	1,269
Spang, Chalfont	10	7,898	1,842	- 6,056	77	- 350
Sloss-Sheffield	21	9,097	2,727	- 6,370	70	1,254
Gulf States	21	5,056	6,361	1,305	26	409
Wood (Alan)	7	- 1,386	944	2,330	168	- 152
McKeesport Tin	10	8,230	7,563	667	8	74
Sharon	17	- 2,673	1,379	4,052	152	520
Allegheny	11	1,646	998	- 648	39	- 173
Stanley Works	21	2,715	10,258	7,543	278	1,050
Byers (A. M.)	20	7,998	14,105	6,107	76	244
Granite City	9	1,471	923	- 548	37	- 2,361
Continental	10	1,923	1,895	- 28	1	381
Acme	16	8,727	3,631	- 5,096	58	—
Follansbee Bros.	9	- 540	- 1,719	- 1,179	218	47
Keystone	21	5,613	3,422	- 2,191	39	53
Ludlum	19	1,587	2,066	419	26	5
Carpenter	12	- 918	1,992	2,910	317	41
Laclede	8	543	4,609	4,066	749	69
Scullin	21	- 292	672	964	330	—
Superior	19	- 393	1,173	1,566	398	42
Eastern Roll. Mill	16	- 388	706	1,094	282	70
Apollo	6	- 442	- 393	49	11	- 164
Atlantic	20	1,125	874	- 251	22	402
Milton Mfg.	8	- 246	438	684	278	41

[a] Companies are ranked by gross plant plus current assets, as of 1935.
[b] After cash dividends. Deficits are shown —.
[c] Adjusted for stock dividends.
[d] Decreases are shown —.
[e] Represents net change in surplus reserves during period. Decreases are shown —.

pany are included in Column 5. There is, obviously, a close connection between surplus balances and surplus reserve balances. But there seems to be little correlation between net surplus adjustments and changes in reserves. Excluding very minor changes, the changes in reserves are almost equally divided between changes which accentuate, and changes which counter-balance, net surplus adjustments. The cases in which reserve changes accentuate net surplus adjustments are slightly more numerous than the changes which tend to counter-balance such adjustments, but again the case is not clear.

NET SURPLUS ADJUSTMENTS, BY YEARS

Total surplus balances of all the companies studied increased markedly in 1916, were reduced in 1920–21 and 1927, increased in 1929, and were reduced in

TABLE VII

NET CREDIT[a] SURPLUS ADJUSTMENTS OF 6 COMPANIES, EXPRESSED AS PERCENTAGES OF PROFITS TO SURPLUS (AFTER CASH DIVIDENDS), 1915–35

Year	*U. S. Steel*	*Republic Steel*	*Am. Roll. Mill*	*Crucible Steel*	*Stanley Works*	*Scullin Steel*
1915	1	− 3	96	0	0	0
1916	0	0	0	0	0	0
1917	−53	0	237	0	0	0
1918	−14	0	− 30	0	0	246
1919	0	0	123	0	− 36	0
1920	−49	− 12	− 13	29	−455	0
1921	− 4	0	82	−1,242	171	0
1922	11	0	381	− 12	0	0
1923	−75	0	3	− 23	0	10
1924	−82	0	49	0	235	368
1925	−84	− 69	2	− 20	− 6	168
1926	−43	− 53	− 2	0	20	8
1927	0	0	70	0	0	2
1928	21	−791	820	0	598	0
1929	−77	− 43	198	0	2	− 37
1930	97	−273	−133	0	− 1	− 5
1931	1	473	− 58	− 30	3	−118
1932	1	11	− 36	− 7	15	− 3
1933	5	17	−246	11	12	0
1934	0	2	− 81	561	3	10
1935	0	510	− 59	72	9	− 17
% Total Change[b]	45%	430%	215%	8%	278%	330%
Assets[c]	$2,880	$420	$149	$141	$20	$9

[a] The percentages are computed as if all changes were positive. Net debit adjustments are computed as above but are indicated as −.
[b] See Table VI.
[c] Gross plant plus current assets, as of 1935, in millions.

1932–34. Profits to surplus varied but slightly from this outline. Profits to surplus were large in 1916–17, and deficits were transferred to surplus in 1920–21. However, profits to surplus were large in 1926 as well as in 1929, and deficits were carried to surplus in the years 1931–34. These changes seem to indicate that the large net surplus adjustments shown in Table VI were the result of a few important adjustments. In order to illustrate this hypothesis, Table VII displays the net surplus adjustments for six companies, by years, expressed as percentages of profits or deficits to surplus after cash dividends.

Included in Table VII are two large companies ranking first and third, as of 1935, two medium-sized companies ranking ninth and tenth, and two small companies ranking twenty-second and thirty-second. The net surplus adjustments for the whole period were very large for four of these companies, small for Crucible

TABLE VIII

PERCENTAGES OF COMPANIES WHICH RECORDED NET SURPLUS ADJUSTMENTS OF 5% OR MORE OF (1) PROFITS TO SURPLUS AND OF (2) NET PROFITS

Year	*Number of companies studied*	(1) *Net Debit*	(1) *Net Credit*	(2) *Net Debit*	(2) *Net Credit*
1915	13	23	15	23	15
1916	15	13	0	13	0
1917	16	30	12	25	20
1918	17	30	35	19	23
1919	19	26	16	21	21
1920	22	40	18	36	18
1921	23	35	35	35	40
1922	24	30	33	33	25
1923	24	42	21	38	25
1924	28	35	32	35	28
1925	28	28	11	28	14
1926	30	53	10	53	10
1927	32	28	25	28	25
1928	33	36	30	33	33
1929	37	43	19	43	16
1930	37	40	16	40	13
1931	37	43	24	57	24
1932	37	38	30	35	33
1933	37	19	49	22	50
1934	37	30	35	33	33
1935	37	46	24	40	22

Steel, and moderately large for United States Steel.

With these data, as with Table VI, it is difficult to find any general pattern. The greater part of the net surplus adjustments for each company were accounted for by a relatively small number of changes, but adjustments were frequent. Including only adjustments of five per cent or more, the six companies averaged eleven adjustments for the twenty-one years, and only American Rolling Mill, with seventeen, deviated sharply from this average.

The frequency with which these nine companies adjusted their surplus balances is typical of this group of companies, as is the absence of any general pattern in the adjustments. In support of these contentions, data are presented in Table VIII which indicate, in percentages, the number of companies of the total studied for each year which reported net debit or credit adjustments in excess of five per cent of (1) profits to surplus (after dividends), and (2) net profits (before dividends).

In only five years of the total did fewer than half of the companies studied for each year fail to record net surplus adjustments of 5% or more of profits to surplus. In only six years of the total did these companies fail to record net surplus adjustments of 5% or more of net profits. It is clear, from these percentages, that surplus adjustments were made frequently by at least half of the companies studied.

When the debit and credit adjustments are studied in relation to profits the same confusion is apparent as was seen in Table VII. A relatively large number of debit adjustments were recorded in 1920–21, 1923–24, 1926, 1929, all years of

TABLE IX

SURPLUS ADJUSTMENTS FOR NINE COMPANIES, 1935–37
(000's omitted)

Company[a]	*Adjustments for*				*Misc.*	*Total*
	Assets $	*Surplus Reserves & Stock* $	*Retirements of Securities* $	*Profits*[b] $	$	$
			DEBIT ADJUSTMENTS			
Bethlehem Steel	16,753	20,428	3,377		526	51,084
Youngstown S. & T.	5,470	17	5,263		780	11,530
Jones & Laughlin	1,854		326		50	2,230
Crucible Steel	485		131		48	664
Republic Steel	2,404	20,091	1,343		651	24,489
Wheeling Steel	2,448		93		2,141	4,682
National Steel	8,239		1,874		374	10,487
Am. Roll. Mill	5,562	372	1,164		2,976	10,074
Inland Steel	3,951	1,653			194	5,798
Totals	47,166	42,561	13,571		7,740	111,038
			CREDIT ADJUSTMENTS			
Bethlehem Steel	2,615	14,688	35	12,940	1,683	31,961
Youngstown S. & T.		3,131	46	14,406	17	17,600
Jones & Laughlin	492	161		3,236		3,889
Crucible Steel	1,731			4,695	3	6,429
Republic Steel		41,105		14,167	17	55,289
Wheeling Steel		354		6,876	529	7,759
National Steel	111			23,911	182	24,204
Am. Roll. Mill		42	205	6,829	987	8,063
Inland Steel		258		17,665	520	18,443
Totals	4,949	59,739	286	104,725	3,938	173,637

[a] Companies are ranked according to gross plant plus current assets, as of 1929.
[b] After cash dividends.

substantial profits; in 1930, when profits were still moderately large; in 1931–32, when losses were reported; in 1935, when small profits were carried to surplus. More net debit adjustments were thus recorded in prosperous years than in poor years. Net credit adjustments were recorded in 1918 when profits were high, in 1921 when profits were low, and in 1933–34 when losses were reported. On the whole, there is little relationship between surplus adjustments, and losses or profits.

CLASSIFICATION OF SURPLUS ADJUSTMENTS

It is difficult to secure comparable data for many of these companies for the entire period studied. The earlier manuals do not show adjustments for many of these companies and, in many cases, the adjustments which are shown are so grouped as to make classification difficult. As a partial substitute for such a classification, data are included for three years' surplus adjustments recorded by the nine leading[16] companies, excluding United States Steel.

The classification adopted in Table IX is arbitrary. A larger number of classes can be used for some of these companies but is impossible for others because various kinds of surplus adjustments are combined. Adjustments to assets include revisions of book value for current and fixed assets and investments as well as for deferred charges. The column for "retirements" includes adjustments resulting from expenses as well as premiums and discounts arising through retirements. In some few cases the adjustments were so combined that even these broad classifications do not suffice.

The surplus adjustments shown in Table IX cover two years, 1936–37, which are not included in the preceding tables. Also, Table IX includes only nine companies of the thirty-seven studied. These data are a sample of this industry, although the companies included are the nine largest after United States Steel, and represent approximately one-half of the ingot capacity of the companies studied. The adjustments shown in Table IX are not representative of the volume of adjustments that have been made by the companies in this industry but are, it is believed, fairly indicative of the types of adjustments that have been made by these companies. Of the four major divisions in Table IX, adjustments of assets and stock and surplus reserves account for the major part of the surplus adjustments.

CONCLUSION

This study represents an attempt to indicate the extent to which estimated profits have been qualified by subsequent revisions of surplus. Emphasis has been placed on that part of estimated profits retained by the individual companies.

The information presented indicates that all but a few of the companies recorded surplus adjustments of amounts sufficiently large to represent significant changes in the surplus balances which would otherwise have resulted from profits and deficits. Approximately one-half of the companies studied recorded net reductions of surplus, the others recording net additions to surplus. Of the thirty-seven companies included in the survey, only seven had net surplus changes which represented less than eleven per cent of profits to surplus.

Some types of surplus adjustments may be of little importance to investors. As an illustration, a change in methods of consolidation may bring about an adjustment of surplus for the year in which the change is made. Such an adjustment would be of interest to investors only if a clear

[16] These nine companies represented 42% of total ingot capacity of the United States as of December 31, 1934. See Daugherty, Carroll R., Chazeau, Melvin, G. de., and Stratton, Samuel S., *The Economics of the Iron and Steel Industry*, 1934, Vol. I, p. 365.

statement covering subsidiaries had not been made in previous years. Probably some indeterminate part of the net adjustments shown in the above tables represents such types of surplus changes. For most of the companies studied, however, the net adjustments are too large to be accounted for by such types of adjustments. If Table IX is at all indicative of the types of adjustments made, the greater part of these adjustments are of such nature as to require important qualifications of reported profits, profits retained, and possible future profits arising out of such retentions of earnings.

For the majority of the companies studied, adjustments of surplus were not only relatively large in amounts but were made with surprising frequency. If the data in Table VII are representative of the groups, the greater part of the net changes recorded over the period can be accounted for by a few large adjustments. However, the data in Table VIII indicate that adjustments were made frequently by a large percentage of the companies. These adjustments do not correlate, as we might expect, with profits and losses. Instead, there is a confused picture of write-downs in good years and write-ups in poor years.

GOVERNMENTAL ACCOUNTING IN THE EDUCATION OF THE PUBLIC ACCOUNTANT

Robert P. Hackett

The 1937 Committee on Education of the American Accounting Association is to be congratulated on the fundamental principles which it has incorporated in its syllabus of college preparation for accountancy as described and set up in the Accounting Review, June 1938. Anyone who has had any experience in shaping and administering such educational programs can hardly fail to agree with the importance attached to the liberal arts subjects. This brief in this respect, however, needs no amplification, since the subject has been well presented by Professor Miller.

Under the title "specialized accounting" provision is made for municipal accounting to the extent of four credit hours if the student elects the *maximum* program. However, if the student does elect this maximum program which would make it possible for him to take such a subject he "would probably be convinced in later years that more work in general subjects would have been beneficial."[1] In other words it is an implied suggestion that a program omitting governmental accounting would be the wisest.

There is no intention here to belittle any particular course set up in this syllabus. About half liberal arts and half business subjects and accounting is a good division. Observation and experience, however, have left the impression that governmental accounting needs more specific mention, certainly in the recommended program if not in the minimum program. An interest in governmental accounting which I believe is an unbiased interest, prompts this conclusion.

There are a number of situations apparent at the present time which should make evident the importance of governmental accounting to the student of public accounting.

There is a definite trend toward state

[1] "Syllabus of College Preparation for Accountancy," Accounting Review, June, 1936, p. 196.

laws requiring all municipalities to have an annual audit by a C.P.A. or otherwise recognized capable accountant. This in itself points toward an increasing demand for accountants able to perform such audits. Most practitioners and educators in accounting recognize the importance of knowing something about this type of accounting as a result of the increased demand which is evident in these times.

I have heard public accountants express a "hands off" policy when municipal audits are mentioned. In searching more deeply for the reason, it all seems to come back to the bidding policy which so many municipalities follow under a misapprehension that the law requires it. Accountants have said that if this "cut-throat" bidding could be eliminated they would be very willing to accept municipal engagements. The National Committee on Municipal Accounting, which has exercised a great deal of influence in its field in the four and one-half years of its existence, recommends that the practice of awarding audits to the lowest responsible bidder be abandoned. No one need doubt that this recommendation will have an effect on the practice. All of this means that there is a definite trend toward more municipal audits removed from political influence.

The practitioner's comment: that he will be glad to see more municipal audits with no politics involved, but he does not see why any special study is necessary serves only to emphasize the importance of the study of governmental accounting. It is only necessary to examine some of the audit reports of municipalities made by accountants, entirely reputable, but with no specific training or knowledge of governmental accounting. There is enough essential difference between commercial accounting and fund accounting for municipalities to make the application of general accounting procedures all but meaningless. This discussion is not intended to be a treatise on governmental accounting principles and procedures. It is enough to say that a material difference exists for which some special study and training is necessary to enable one to take advantage intelligently of the additional audits that are imminent.

Many municipalities have recently gone through a trying period. Inadequate and improper records have increased the difficulties in which they found themselves. During this period the recommendations of the National Committee on Municipal Accounting were published; coming at the height of these practical difficulties, the recommendations furnished a perfect setting for the desire on the part of many cities to install new and correct accounting systems. This movement is under way. It cannot help but increase in intensity. Public accountants have been and will continue to be called upon to assist in the building and installing of these systems, a process which requires special knowledge of municipal accounting principles and procedures. A system installed along general accounting lines alone would ignore many things that are fundamental in governmental accounting. The public accountant without this training will certainly be at a disadvantage compared to those that have such knowledge.

There is probably no field of accounting in which a greater opportunity for "missionary" work exists. The field of governmental accounting has received as little recognition as any, but the education of those who will keep the records cannot go far until those who are to install and audit the records understand the proper procedures to follow. Our governmental units have a larger dollar volume than any other "industry," but there is probably no industry in which less adequate accounting systems may be found. If for no other reason than that the field will offer so many opportunities under conditions

which will undoubtedly be more favorable in the future, the public accountant should be interested in knowing more about governmental accounting.

The young man who is training for public accounting is thinking not only of training as such, but also of the examination which he must take in order to practice as as a public accountant. An observation of certified-public-accountant examinations in the near past shows an increasing number of governmental accounting questions with increasing value. Apparently the examiners who are preparing examinations are aware of the importance of this field and will not allow the candidate to ignore it. In other words, governmental accounting should be studied by the prospective public accountant not only because he may meet such a question on an examination, but also because he should know governmental accounting so that he may better meet his everyday problems.

One further consideration should be mentioned. The increasing scope of public business in municipal, state, and Federal governments should be recognized. The accountant will be looked to as the one who can meet this situation, but if his training has included nothing on this special problem he will not be ready.

It may be that the failure to give more importance to governmental accounting is attributable to the lack of a widespread offering in colleges and universities comparable to other accounting subjects. Education for the aspiring accountant should not be measured by what is available, but by the value and need of certain fields of study. The courses offered should fit the need of the student and not the desire of the school.

THE POSITION OF THE GERMAN ACCOUNTANT

A. Matz

From September 19th to 24th, 1938, occurred the Fifth International Congress on Accounting in Berlin, Germany, which brought together German accountants and trustees, and representatives from approximately forty foreign nations. This convention was again the occasion for discussions on the real status of the accounting profession within the new national pattern. To indicate the position of the German accountant is the object of this paper.

The last five years have brought an abrupt about-face in political, cultural, social, economic and professional thinking in Germany. No phase of national life has remained untouched. Because the efforts and endeavors of every individual are first to serve the welfare of all the people, the education of the individual to the ideology of National Socialism is a most necessary prerequisite. While alignment to the new pattern was accomplished very quickly in many fields, the professional occupations remained aloof from the new mode of thought; but now, with the aid of legal and educational forces, they, too, are following the trend. Among the professions, the accountant, whether private or public, has always occupied an honorable and important position.

In order to understand the situation in which the German accountant now finds himself, it is first necessary to consider the changes in economic and political philosophy. Then it will be possible to outline the problems of the individual accountant.

Traditional liberal German philosophy recognizes a division of national life until

public and private spheres. The private sphere is primary. And the encroachment of government upon the activities of the individual is considered an unjust limitation of his personal rights. Today, the entire life of the German nation lies within the sphere of the destiny of the German people. Business leadership is requested by the state, but the state does not conduct business itself. The creative power of private initiative and responsibility is desired and encouraged by the state. But the state also insists that the efforts of the individual shall not be harmful or destructive to the entire group.

The professional accountant, as an auditor, tax consultant, cost accountant, or trustee, had too often become the dependent and willing servant of private businesses, protecting his clients against the state which acted as collector of revenue, or bringing harm to competitors or private investors.

Today the public accountant does not occupy any official or governmental position. He is still a free professional man. But his sphere of activities has been projected from the small private-business enterprise which formerly he served into the interest and welfare of the entire nation. He has become the exponent of a governmental function insofar as his new duties and responsibilities require him to consider first the advantage of the entire economic life and welfare; only secondarily does he consider the gain or profit of the enterprise examined. This close relationship of the accountant to the state is correlated with a like close connection with the business world. While state and public expect a clear and truthful presentation of the annual balance sheet and income statement, the enterprise examined expects on the other hand not only a formal, but also a very critical, constructive and all-inclusive examination with regard to its economic fitness and financial well-being. The accountant's line of vision must always include the interests of the entire nation first, regardless of whether this is to the advantage or disadvantage of the enterprise. Yet, the accountant's professional independence creates confidence in his integrity.

This discussion concerning the German accountant's position between state or public on one side and business on the other can best be summarized with the following definition: "Wirtschaftstreuhänder is one who acts in private and public affairs as examiner, consultant, and trustee, the goal of these duties being to maintain a well-ordered national economy."

The German word "Wirtschaftstreuhänder" can not easily be rendered in English. It includes all those professions which in the world of business necessitate a confidential and trustworthy position. Therefore the certified public accountant, the auditor, the officially admitted tax consultant, the trustee or any person who advises in matters of foreign currency exchange all fall into the category of the above collective title.

As such, a "Wirtschaftstreuhänder," whatever subdivision he may belong to, is a member of two distinct professional organizations: the National Socialist Jurists, and the "Institute of Accountants." The first organization is national in scope and includes all those persons whose activities are of legal, judicial or confidential nature. The inclusion of the accountant in this group indicates the modern trend to associate him more closely with the legal division of the German Labor organization rather than with its purely business or economic division. This group administers the political, philosophical and other supervision of the profession with respect to the entire nation. It teaches and trains the "Wirtschafstreuhänder" to think in terms of the new philosophy of state so that he may incorporate it in his work.

The second organization, "The Institute of Accountants" was given an officially legal standing by a decree of the 14th of June, 1934 which required every accountant to be a member. Its main office is in Berlin with twelve branch offices distributed over the country. The tasks of the Institute are manifold and include the following:

1. Coöperation in connection with the admission, examination, certification and revocation of the accounting licenses.
2. Representation of the profession.
3. Seat and voice when new legislation is being considered.
4. Construction of uniform standards for the practice of the profession.
5. Supervision of these duties and standards.
6. Administration of the court of honor of the profession.
7. Maintenance and promotion of the legal, professional and economic affairs of the group.
8. Scientific development of the profession.
9. Furtherance of young members and their education.

Today the Institute supervises and places especially great emphasis upon the fair and proper practice of standards within the profession. The peculiar role of the profession of "Wirtschaftstreuhänder" as a bearer of public confidence necessitates rules and regulations which assure this trust and reliance. Therefore standards of ethics are pillars upon which the profession is built. These standards are indeed the same as those existing in other professional groups but they are modified here with regard to the need of the profession itself.

At the time of his admission into the profession the new accountant takes this oath: "I swear that I shall fulfill the tasks and duties of a public accountant conscientiously and impartially, observe discretion in all matters, and render all statements conscientiously and impartially."

This oath is important because by establishing professional independence it makes logical corollaries of a number of principles, the first being "Sole responsibility": which means that the accountant alone is responsible for his actions and opinions. He can no longer shield himself behind an impersonal organization. This sole responsibility does not apply to the examiner or accountant who is employed in an auditor's office or to the accountant who enters into a contract with the firm under examination, where an employer-employee relationship exists.

In order to preserve this professional independence and sole responsibility, the Institute has limited the accountant's practice and prohibited him from being at the same time:

a. A participant in any other kind of commercial undertaking.

b. An employee in a different type of business.

c. A legal tax representative or a member of the board of directors of an industrial concern.

d. A governmental employee.

e. An employee in the Department of Revenue.

Professions or activities which the C.P.A. can also follow are all free professional positions such as legal, technical or economic adviser, teacher, writer or publicist. But in all these cases emphasis is placed upon his chosen profession as an accountant.

By his oath the "Wirtschaftstreuhänder" is held to a strict accountability in all his tasks and duties. Any breaking of this promise can be prosecuted by the court of honor which is a part of the Institute. Disciplinary measures will be taken when "irresponsibility" has been detected. Any accountant who violates

the professional code of ethics can be called before the tribunal. The following judgments can be rendered against him: (1) warning, (2) reprimand, (3) payment of a sum up to 1,000 marks, and (4) the revocation of license and exclusion of the member from the profession.

The same rules and regulations hold for the legally admitted examiner, the auditor, the tax consultant, or the trustee.

The foregoing discussion indicates that the "Wirtschaftstreuhänder," keeping in mind the various groups he comprises, is in modern Germany the mediator between government and business. Upon his shoulders rest (1) the execution of the new philosophy of state with respect to the entire nation, and (2) his close coöperation with business in order to aid, criticize, suggest, examine and bring about its successful function in society.

ACCOUNTANTS' LIABILITY TO THIRD PARTIES: THE ULTRAMARES CASE REAFFIRMED

WILLIAM W. BRADY

IN 1931, the New York Court of Appeals in the case of *Ultramares* v. *Touche* (174 N.E. 441) handed down a decision concerning accountants' liability to third parties that has become a milestone in accounting jurisprudence.

On May 28th of this year, in the case of *State Street Trust Co.* v. *Ernst*, (15 N.E. (2d) 416), the same court reaffirmed the major principles of the *Ultramares* case. In an action against the accountants by third parties not contracting with the accountants (the plaintiff bank made a loan on the basis of the certified statement), the court held that the question of liability could go to the jury on an issue of fraud as to whether the accountants had a *bona fide* belief in the truthfulness of their certificate.

With the *Ultramares* doctrine thus more firmly entrenched in New York, and widely followed in related cases in many more jurisdictions (see list of cases, Shepard's Citations under 255 N.Y. 170, 174 N.E. 441), it is believed that a review of the findings, together with their application to the facts found in the case decided this year, will be of interest to the practicing accountant.

This article, therefore, will be divided into two sections:

1. A review of the findings in the *Ultramares* case;
2. A review of the facts found by the court in the *State Street Trust* case, illustrating the type of auditing errors which may bring the accountant within the scope of liability set out by the *Ultramares* decision.

The *Ultramares* case made three contributions to tort law in New York:

1. Negligence is insufficient basis for determining liability for innocent misrepresentation.
2. An untrue certificate of fact is a sufficient basis for determining liability for fraud—in other words, express intent to deceive need not be shown.
3. An incorrect certificate of opinion is not a sufficient basis for determining liability for fraud *unless* the grounds supporting the certificate are so flimsy that they indicate a lack of good faith sufficient to raise an inference of fraud—the "flimsy grounds" will take the place of intent to deceive in this action, and express intent need not be shown.

Each of these three points will be

briefly discussed in an effort to illuminate the major principles of the *Ultramares* decision.

1. Prior to the *Ultramares* case, only one attempt has been made by third parties to hold accountants liable for negligence. In *Landell* v. *Lybrand*, a Pennsylvania case decided in 1919, it was held that there could be no liability to third parties not in privity of contract with the accountants. Of course, the client or other party contracting for the audit has the right to expect work of a quality commensurate with that usually characterizing the work of others in the profession, and negligent performance will subject the accountant to liability to the contracting party.

In the 1920's, however, three cases in New York seemed to point towards adopting the negligence formula for words negligently published and relied upon by third parties. Liability was found:

1) Against a public weigher hired by the seller, but furnishing his certificate to the buyer—the buyer sued successfully (*Glanzer* v. *Shepard*, 1922);

2) Against a railroad for furnishing false information to the consignee, when it knew that the information was going to be used for obtaining insurance and could not be ascertained elsewhere—the consignee sued successfully (*International Products Co.* v. *Erie R.R. Co.*, 1927);

3) Against a trust company when it falsely certified certain assets to be held in trust and thus induced plaintiffs to purchase trust certificates (*Doyle* v. *Chatham & Phenix National Bank*, 1930).

These cases all found liability to third parties for negligence. In the *Ultramares* decision, however, the then Chief Judge Benjamin N. Cardozo carefully distinguished them from accounting liability, inferring they would be more properly handled under the "deceit-certificate of fact" theory (second division herein).

He definitely held that in the absence of contract there could be ***no liability for negligent misrepresentation***, and in the *State Street Trust* case a similar unqualified declaration was made.

2. In the *Ultramares* case, Chief Judge Cardozo stated that "if their statement was false, they are not to be exonerated because they believed it to be true." Plainly stated, this means that anyone certifying to a fact, as of his own knowledge, will be liable if his statement is false, regardless of his grounds or of his intent. The accountants' certificate in the *Ultramares* case stated as a fact that the balance sheet was in accordance with the accounts. In the *State Street Trust* case, no such certificate as to a fact was made. It may be fairly said that accountants' certificates since the *Ultramares* cases are carefully worded to show that they represent solely the accountants' opinion. When inclination or necessity point to an accountant making any certificate as to a *fact*, he should take heed of the strict liability attached thereto.

3. The *Ultramares* case precluded liability of accountants to third parties on grounds of negligence, but it declared that there could be liability if a jury could find "a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truthfulness." That is, gross negligence could establish liability when mere negligence would not. The nature of the action would be in fraud, and the "flimsy grounds" stated above would take the place of actual intent to deceive. The right to sue would extend to all who relied on the certificate and whom the accountants might reasonably expect would be making such reliance.

In the *State Street Trust* case, the majority of the court felt the jury should decide as to whether the grounds were "so flimsy as to indicate a lack of good faith

sufficient to raise an inference of fraud," and directed a new trial with the submission of that single question to the jury. Two judges dissented, holding that the evidence was not sufficient to require jury determination, i.e., that a directed verdict of "no liability" should be given. The case had been tried to a jury originally, which found for the plaintiffs. The trial court set aside this verdict and gave judgment to the defendants. This was approved by the appellate court, but the Court of Appeals, New York's highest court, reversed the judgment and ordered a new trial.

The pertinent facts of the *State Street Trust* case are as follows: The company was engaged in financing wholesalers and mills, lending money and taking as security inventories and assignments of accounts receivable. It would advance funds for manufacturing operations and would be repaid mainly by money received from the assigned receivables.

It applied to the plaintiff bank for a loan, submitting an uncertified balance sheet and stating that the defendant accountants had not yet completed their annual audit, which they were making for the third successive year. The bank refused to make the loan until a certified statement was given them. The certified statement, substantially corroborating the company-prepared balance sheet, was later furnished the bank and the loan was consummated. The loan was renewed several times, the bank's officer stating at the trial that the renewals were made solely on the basis of the original certified statement. A year later the company was petitioned into bankruptcy. The certified balance sheet showed a surplus of $83,000, when in fact the deficit and impairment of capital was over half a million. The bank sued for the resulting loss.

The court conceded that the accountants' client was deliberately dishonest. It made old and probably uncollectible accounts appear good by causing payments to be made on them by another company owned by the client. It further induced one Saqui, who freely admitted his own dishonesty and testified for the bank, to furnish them false inventories and assign a great many false and fictitious accounts.

But the majority of the court also felt that the testimony was replete with evidence, oral and documentary, which established a *prima facie* case of gross negligence against the accountants. The particular incidents upon which the court relied in making this conclusion may be listed briefly as follows:

1. Failure to include qualifying letters with, or to refer to a qualifying letter in, the 10 certified statements originally furnished the client by the accountant, although a month later the qualifying letter was included with, and referred to in, an eleventh certified balance sheet furnished the client. The letter clearly indicated the accountants' lack of general belief in certain major balance-sheet items.
2. Failure to indicate the sluggish condition of or to provide an ample reserve for "Commission Accounts Receivable."
3. Failure to establish a reserve for "Commission Account Advances—Inactive and In Liquidation."
4. Failure to make any audit of $125,000 of apparently "dead" accounts beyond receiving a letter from the client's treasurer that there was sufficient collateral behind them.
5. Miscellaneous auditing deficiencies.

A more detailed discussion of each of the above points follows.

1. Ten certified balance sheets were sent to the client on April 2, 1929, the accountants knowing they were to be used for obtaining credit. A month later another balance sheet was sent, identical to the prior ones except for the notation that

it was "subject to the comments contained in the letter attached to and made a part of this report." This covering letter contained vital information concerning the condition of many balance sheet accounts (to be discussed later).

According to the court, the letter not only indicated the accountants' lack of general belief in the correctness of certain major balance sheet items, but the failure to include it with the original balance sheets, or to make any reference to it therein, constituted the "*equivalent of active misrepresentation*" (that is, the equivalent virtually of an express intent to deceive). Further, the court held "it was gross negligence and an important piece of evidence raising an inference of fraud."

2. The second largest item on the balance sheet was shown as follows:

"Commissions Accounts Receivable —secured by merchandise
Advances...........$2,043,337.81
Less Allowances.........19,767.15

$2,023,570.66."

This constituted funds advanced to various customers to finance manufacturing operations and represented one-quarter of the total assets. According to the accountants' statements in the covering letter, a very large proportion were "comparatively inactive during the year and appeared slow of collection."

Of the two million in these accounts receivable, $768,000 represented unpaid advances at the end of the year equivalent to 125% of the total advances during the year, seemingly a vivid warning of their declining value. These advances represented 38% of the total amount of commissions receivable, and 27 out of 55 borrowers included in this classification. Furthermore, in the previous year the audit report had stated, when similar accounts were equivalent to 65% of total yearly advances instead of 125% as here, that the accounts "had excessive advances as measured by their sales volume, which indicated probably excessive or slow moving inventories."

Whether the "allowance" of $19,000 was meant to be a reserve for bad debts or a reserve for other purposes is not clear. If a reserve for bad debts was intended (which the court assumes), then it would have been more than absorbed by the account of Wardener. Wardener went into bankruptcy in 1924. No payments had been received since then, although the account had been padded by monthly interest charges during the entire period. The court held that even though the accountants might not be expected to know of the bankruptcy, the fact that no payments had been made on the account for five years should have warned them to provide a sufficient reserve.

The accountants' handling of this account, in their failure to provide a reserve for uncollectible accounts or to indicate the sluggish condition, was held by the court to be evidence from which the jury might find liability on the grounds that the accountants had "no genuine belief in the truthfulness of the balance sheet figures."

3. The accountants listed as a noncurrent asset the following:

"Commission Account Advances—Inactive and In Liquidation........
$215,124.72."

Many of these accounts had had no transactions for many years, although the books showed continued inflation of the accounts by interest charges during the entire period. These interest charges were in fact added to one account, although on the face of the books it appeared to be in bankruptcy. The covering letter indicated that the accountants had complete

knowledge of all these facts; at the trial, the accountants contended that by their description of the account as "Inactive and In Liquidation" and by listing it "below the line" as a noncurrent asset they had discharged their auditing responsibility as to this particular item. Expert testimony was presented to the effect that placing an item "below the line" merely signifies that it is not current and in no way indicates the accountants' disbelief as to the accounts being worth their full value. The experts further testified that a reserve of at least $150,000 should have been established unless investigation showed the accounts to be of full value.

4. No investigation of $125,000 of apparently "dead" accounts included in this group was made by the accountants after receiving a letter from the client's treasurer to the effect that the client had in its possession "sufficient salable merchandise to completely liquidate" the accounts. The court felt that under all of the circumstances of this account, the failure to provide a reserve after sufficient investigation was another ground for the jury to consider in ascertaining whether the accountants had "genuine belief in the balance sheet."

5. Other miscellaneous auditing deficiencies listed by the court were:

1. Failure to set up a reserve for $72,000 of accounts receivable, described by accountants on their worksheet as "Ocean Bankrupt Accounts." The accountants contended that no reserve was established because the accounts were covered by credit insurance, but the court held that a cursory examination of the insurance policy would show that $32,000 of the accounts had no coverage whatsoever.

2. Listing of a $10,000 demand note without reserve. The note was overdue and no payments had been made on it, although an attorney had been attempting to collect it for two years.

3. Failure to make a more extended examination of a certain account receivable, whose monthly sales up to December of the current year never exceeded $191,000 and averaged $129,000, but whose December sales jumped to $491,000, including $300,000 of wholly fictitious sales.

4. Failure to use correct figures for reserves for bad debts and discounts. The accountants' work sheets for the previous year showed a computation of the reserve along customary accounting lines, but the provision for bad debts according to this computation would have reduced profits below the amount of dividends declared. Therefore, an arbitrary reduction of the bad-debt provision was made to a point where profits could exceed dividends for 1927, and in 1928 the same reduced provision was adopted.

In summary, the Court of Appeals held that all of the foregoing indicated sufficient evidence from which the jury *might* find that the accountants had no *bona fide* belief in the truthfulness of their certificate. It is to be emphasized that no jury determination has as yet been made on this precise question, the defendant accounts have not as yet been found liable, and the alleged auditing deficiencies are merely the court's description of what it has found in the evidence, a sufficient amount of which must be proved to the jury in the new trial for them to decide that the accountants had no *bona fide* belief in the truthfulness of the balance sheet.

It is of interest to practicing accountants to know what type of auditing error or omission will allow a case for liability to third parties to go to the jury, as compared with those lesser errors of mere negligence which will receive a directed verdict of "no liability" from the judge. It is only from cases such as the present one that such information may be obtained. The cases are not at all frequent, and the ac-

countant must proceed by analogy from the incidents described in decided cases to determine whether other types of errors or omissions will make for a jury question. The only other case on this point since the *Ultramares* decision is that of *O'Connor* v. *Ludlam* (92 F.(2d) 50), decided in the Federal circuit Court of Appeals sitting in New York City. There it was held that fraud arising from gross negligence could not be found where the accountant honestly misconceived the legal significance of a document.

It is submitted that conscientious accountants with a long-range view towards the enhanced future and value of their profession will welcome a certain degree of responsibility even to third parties, for the value of the public accountant's work and of his certificate may be measured only by this responsibility and liability.

The sole purpose of virtually all certified balance sheets and profits statements is to indicate to persons other than the management financial condition as disclosed in an independent investigation made by experts. Great dependence is placed upon it, and accountants naturally welcome and seek increased confidence in their certified statements. With an inconsistency that is perfectly human, however, they seek to avoid liability resulting from this reliance. Of course, as the learned Chief Judge Cardozo eloquently expressed it in the *Ultramares* case:

> The range of the transactions in which a certificate of audit might be expected to play a part is as indefinite and wide as the possibilities of the business that is mirrored in the summary.

Some reasonable limit must be placed on their liability. The New York court has already indicated three major restrictions on finding accountants liable: (1) gross negligence amounting to fraud must be proved (mere negligence will not suffice); (2) reliance on the certificate must have induced the loan, or other transaction; (3) the accountants knew such a reliance might reasonably take place. Protection to accountants may come from insurance, to which the medical profession has widely resorted or from qualified certificates; but the chief hope to both the practitioner and the public must lie in increased vigilance and in a larger sense of responsibility to third parties.

THE PERSONALITY FACTOR IN ACCOUNTING SUCCESS

MARVIN L. FREDERICK

TO SOME people an accountant is still a human adding machine. It may be true that his success is dependent to a considerable extent upon his aptitude for handling figures, but the leading positions in this profession rest in the hands of those who combine this aptitude with an even more important qualification, *the ability to negotiate.*

To negotiate means "to conduct communications or conferences as a basis of agreement." Therefore a second party is always involved and the ability to meet people and to deal with them successfully is an essential part of the makeup of a successful accountant. Even the earliest steps in private accounting afford many opportunities to demonstrate this ability because few jobs, even at the beginning level, fail to require considerable negotiating to get information to complete an assignment.

Students specializing in accounting are, for the most part, woefully ignorant of

the necessity of developing this ability and therefore concentrate on the theory as found in books and in problems to the exclusion of experience in making contacts with individuals. Students who have a natural aptitude for dealing with people sometimes avoid accounting as a career because they are not sufficiently familiar with the satisfaction which an accountant experiences in the way of contacts. Therefore, many young men who would succeed as accounting executives select other careers because they want jobs in which they "meet people" rather than those "pore over figures all day long." These very phrases have been used by hundreds of college seniors whom I have interviewed. They knew I was looking for prospects for positions in which accounting experience is emphasized as the background for other corporate activities or as the first step in an accounting career.

My experience in following through more than a thousand of the young men who decided to start with accounting leaves me with the distinct impression that the number of young men who find accounting work more interesting than they expected it to be outnumber considerably those who find it otherwise.

I doubt if college professors realize how great an influence with respect to the choice of a career they exert upon their students. In some schools which I visit, accounting is avoided as much as possible because the courses are difficult and uninteresting and students get "fed up" on theory before they secure any practical experience. In one school nearly everyone preferred marketing and advertising due to the inspirational way in which those subjects were taught. It is only recently that any of the students have begun to specialize in accounting. It is a pleasure to find a school, and there are quite a few, where the accounting courses are thorough, and therefore quite difficult, but which attract many of the better men because of the inspirational quality of the instructors and the results they get in placing their men in satisfactory positions upon graduation.

The lack of actual accounting experience on the part of some instructors and the inability of a student to visualize just what an accountant actually does in a given organization promotes the feeling that accounting is sedentary, solo work. Many times some placement director or professor has recommended a young man to me with the statement that "he has a keen mind and although he doesn't have a very good personality, he ought to make a good accountant." This shows the faculty's ignorance of the high standard with respect to personality which companies are now setting in selecting young men for training to become accounting executives.

There are over five-hundred employees in the Comptroller's Department of the General Electric Company, and the work is so subdivided that each person does only a small cross-section of the work as a whole. This fact emphasizes the dependence upon others to get information to complete a particular assignment and consequently promotes personal contacts with fellow workers in different levels of responsibility. The reputation of each worker therefore rises or falls with his ability to make these contacts successfully. This success or failure is recorded on his periodical rating sheets under the classification "impression on others," i.e., whether it is highly pleasing, generally pleasing, or not altogether satisfactory. Very frequently further comments along this line are made to answer the question, "What outstanding characteristics will help his advancement?" such as, "successful in dealing with people," "pleasant personality," "coöperative worker," "gets along well with people in other departments," "willingness to coöperate," "is

ambitious and has enthusiasm for his work," "persistent in his work and always willing to lend a hand." On the other side of the picture we find comments like these: "should be more persuasive in his contacts with other men," "is too complacent," "still quite collegiate," "odd personality," "individual worker," "has a know-it-all attitude," "overbearing in his regard for the opinion of others," "lacks initiative," "lacks confidence in himself," "has a tendency to act childish," "too timid," "tries to attract attention continually," "has a habit of prying into things which do not concern him," "has tendency to be sarcastic," "shy—hesitates to express his views," "should try to express himself more clearly—more convincingly."

In an effort to shed a little objective light on this question of what a beginner in accounting actually does during his working day, I sought the assistance of the members of the Schenectady Alumni Chapter of Beta Gamma Sigma and other recruits in our Business Training Course in getting the hourly diaries of fifty young men with less than two years' experience to find out what they actually did during a normal working day. Several specific diaries will be of assistance in visualizing what a beginner actually does and in determining what opportunities he has for meeting people.

One young man, who joined the Company in November 1937, occupies the "Invoice Audit" desk in the Disbursements Division. From 8 A.M. to 9 A.M. on the day selected he sent out those invoices from the preceding day which went to district offices, factories, etc. From 9 A.M. to 12 noon he sorted the incoming mail, put through rush invoices which entailed a trip to the Traffic Department for an OK. Called a man in the Orders and Stores Department regarding a shipping charge, and a man in the Traffic Department about a freight charge. Took a rush approval to the Assistant Manager of the Contract Service Department and another to a section head in the Publicity Department. During the early afternoon he wrote letters to vendors and district offices and checked payments on incoming invoices which appeared to be duplicates. During the latter part of the afternoon he put through afternoon mail, again taking care of the rush jobs which meant another trip to the Contract Service Department and one to the Purchasing Department to get approvals. All of this was a part of the accounts-payable routine.

Some years ago one of the young men who had a similar assignment requiring much walking from office to office and building to building was asked what job he held in the Accounting Department. His reply was that he was a "traveling auditor."

A young man who joined the Company in September 1936 describes his work as assistant section head of the Requisition Audit Section of the Receipts Division as follows: Forenoon—"Read incoming mail and outgoing mail and then visited successively the Industrial Sales Department, the Central Station Sales Department, the Radio Department, and the Transportation Sales Department for information for price index. Reviewed journal entries." Afternoon—"Visited Reports Section of the Statistics Division for information on orders received for price index report. Read incoming and outgoing mail. Assembled information for special report on Apparatus & Supply discount structure (worked with two others on this report). Read incoming and outgoing mail. Studied possibility of simplifying filing system." This can be recognized as pertaining to accounts receivable.

A typical case of a worker in the Statistics Division is that of a young man who began working in June 1937. His particu-

lar assignment was that of report clerk dealing with statistics of orders received by lines and by geographical distribution. He outlines his duties as follows: "8 A.M. to 10 A.M. preparing Local Office Classified Report, checking it and balancing it with control schedules and rounding off figures into thousands. This required no contact with others. 10 A.M. to 11 A.M.—prepared and mailed report of Orders Received in Industrial Control. Worked with typist and assistant section head. 11 A.M. to noon, received letter from a distrrict lighting specialist concerning failure to receive a certain report. This investigation required contact with my section head and with two section heads in the Publicity Department. 1 P.M. to 2 P.M.—using calculator to compute percentages. 2 P.M. to 3 P.M.—copying large orders for report and posting references. Went to see assistant section head of another section of Statistics Division for information. 3 P.M. to 4 P.M.—obtaining references for credits appearing on a certain tabulation. This meant getting information from the section head of another section of the Statistics Division and consulting with one of the young men in the sorting and tabulating section. 4 P.M. to 5 P.M. completing report for typing." This work is classed as internal statistics and comes under the Comptroller as part of the record keeping for the Company.

Quite a few assignments require fewer contacts than the three cases described in detail, but some require many more. A general summary shows that of the fifty cases investigated, five entailed contacts only with people in the immediate section, nine required looking up people in other divisions of the Comptroller's Department and thirty-six reached out into other departments of the Company (with sometimes as many as ten people per day) for information to complete the job.

Most of the young men with three or more years of experience have correspondingly more important contacts to handle. Those who are section leaders must plan and direct the work of those under them on the one hand, and confer with department heads on the other. The ones who are out in the field as traveling auditors must deal with the executives of subsidiary companies and with the managers of outlying departments. In the still higher administrative positions such as Assistant Comptroller, Auditor of Disbursements, Statistician, Assistant Treasurer, Tax Accountant, etc., it is difficult to find a minute when each of these does not have someone in his office conferring on some item of Company business.

To lay out a program which would enable a young man to develop those favorable personality traits which assure successful negotiation with others requires careful planning and unusual effort, particularly if there is little natural aptitude for social contacts. During the four college years extracurricular activities afford the best medium. It may be difficult to visualize how an afternoon on the practice gridiron, or in the office of a student publication, or on the stage of the dramatic club could contribute much to the success of an accounting executive. It might seem as though the afternoon should be spent in the accounting laboratory. Of course it would be tragic if too little time were spent on mastering the fundamentals of debits and credits, balance sheets and profit-and-loss statements. What is needed to promise success is a high level of scholastic achievement plus an activities record which has brought the reward of personality development. These are the two principal indexes used by employers in selecting candidates.

Beginning a career in accounting is very much like starting to work on an intricate jig-saw puzzle. A jumble of seemingly unrelated bits appear before the eye but as several pieces begin to fit together the design begins to take shape and eventually

the completed picture lies before you. The patience required to work out a jig-saw puzzle is small compared to that required in getting a foundation for an accounting career, although the frequent contacts with people make the work less tedious. "A little knowledge is a dangerous thing" in accounting but a person who is sure of his fundamentals will have little difficulty in adapting his knowledge to specific business transactions. The first few years of actual experience form the groundwork for judgment and common sense. These can never be developed from theoretical study. Assignments may seem very simple and they may seem to have very little responsibility connected with them but they constitute *actual business* and if the beginner will consider these first years as his interneship and do every task patiently and intelligently, he will find his work increasing steadily in importance and responsibility. His aptitude for accounting plus his personal qualifications of leadership will, in time, land him in a position where, instead of doing sedentary, solo work, a line of people will be constantly waiting outside his office door and he will have such a steady flow of negotiating to take care of that he will have very little time for reflective, individual effort.

EDUCATION AND TRAINING OF ENGLISH ACCOUNTANTS

MARY E. MURPHY

THE PROBLEM in contemporary business education of determining the proper emphases of theory and of practice is admirably illustrated in the education of accountants in England. The few universities offering accounting courses, notably the University of London in its Department of Business Administration, stress the development of a general intellectual background which may be drawn upon when future problems are presented.[1] English business men as a whole do not believe that an academic training in theory is a substitute for practi-

[1] Accounting courses at the London School of Economics, 1937–8 include Acctg. Pt. I (28 lectures and classes): *1st term:* general introduction as to nature, objects and utility and accounting theory of double entry and structure of accounting system; goods account and trading account; trial balance and subsequent adjustments; outstanding expenses, prepayments, bad debts and depreciation; profit and loss account and balance sheet. *2nd term:* books of original entry and division of ledger; sectional balancing; suspense accounts and accounts current; receipts-and-payments accounts and income-and-expenditure accounts; adaptation of accounting principles and records to various cases, e.g., partnerships, branches, departments, consignments, hire-purchase, royalties, packages; joint stock companies. *3rd term:* the distinction between capital and revenue; valuation of assets and liabilities; depreciation further considered; reserves and sinking funds; interpretation of balance sheet; Companies Act 1929; manufacturing accounts; general nature of cost accounts; checks against fraud, availability of profits for dividends.

Texts used: Rowland and Magee, *Accounting* Part I; Cropper, *Bookkeeping and Accounts*; Carter, *Advanced Accounts*.

Accounting Part II (26 lectures and classes) *1st term:* nature and treatment of goodwill; depreciation and reserves, disclosed and undisclosed; the legal precedents as to company dividends. *2nd term:* accounts as an instrument of control; mechanical aids; reconstructions and mergers; holding companies; consolidated balance sheets; foreign currencies in accounts. *3rd term:* the distinctive features of accounts of special undertakings, e.g., railways, banks, insurance companies, trusts; the general scheme of British income tax and its effects on accounting.

Texts used: Dicksee, *Depreciation Reserves and Reserve Fund;* Dicksee, *Office Machinery;* Dicksee, *Goodwill and its Treatment in Accounts;* Leake, *Depreciating and Wasting Assets;* Leake, *Commercial Goodwill;* Rowland, *Depreciation Reconsidered;* Cutforth, *Methods of Amalgamation;* Cutforth, *Foreign Exchange in Accounts;* Rowland, *Students' Income Tax*. Works and Factory Accounting and Cost Accounts (15 lectures): application of principles of cost accounting to undertakings of various types; accounting for materials and for labor; principles of allocation of on-cost; time factor and machine method; problem of joint costs and by-products; process cost accounts and standard costs;

cal business experience.[2] They frequently contend that no phase of business can be learned without exposure, over a period of time, to practical situations.[3] That this mind-set exists cannot be denied and anyone attempting to attack an educational problem in England, whether it concerns education for accountancy or for any other business profession, must at the start overcome the prejudice which lies deep in the mind of the older generation of business men in that country. Dr. J. A. Bowie has declared that the schools of business of the British universities should be turning out 40,000 graduates annually whereas under actual conditions the number is between two and three hundred.[4] The total number of individuals enrolled in university courses in business administration in the United States is eighty times greater than the number electing such courses in Great Britain.

There is a complete lack of coördination between business and the universities. The universities are in no way connected with training for the profession of accountancy and the profession is similarly not concerned with accounting education in the universities. It has been suggested that the two important English professional organizations, namely the Institute of Chartered Accountants in England and Wales, and the Society of Incorporated Accountants and Auditors, should become interested in accounting courses at the universities, and in the development of curricula satisfactory to the institutions and to the profession.[5] One of the leading English accountants has concentrated attention upon this problem by his statement: "So far as I am aware the Institute and the Society have not directly concerned themselves with the academic study of accountancy or research work, and apart from the setting of examinations and financial support given to students' societies, they have not concerned themselves directly with the educational methods in force within the profession itself."[6]

As the matter now stands, there are few accounting textbooks in existence which could be used by the elementary student[7] although there is a large number in the field of auditing.[8] Almost no emphasis is placed upon the interpretation of accounts and statements and there is almost no discussion of accounting in relation to economics. Sir Josiah Stamp has continually urged accountants to engage in research: "Scientific accountancy has been develop-

cost accounts on double entry basis; reconciliation of cost and financial accounts; application of principles of cost accounting to selling and distributing expenses.

Texts used: Smails, *Work of a Cost System;* Brigg, *Cost Accounts;* Wheldon, *Cost Accounting.*

Graduate Courses: Management Accounting (one term): Course designed to acquaint students with technique and methods of accounting as an instrument of management control; use and limitations of balance sheets as indices of financial standing and results.

Modern Tendencies in Accounting (one term, 3 lectures): Reactions of modern conditions on practice of accounting, particular reference being made to machine methods and to problems arising out of inter-company organization.

[2] *Accountant,* Sept. 12, 1931, pp. 365–366.

[3] Bowie, J. A., *Education for Business Management,* London, Oxford University Press, 1930, pp. 127–131.

[4] *Accountant,* Sept. 21, 1935, p. 396.

[5] *Accountant,* July 24, 1926, pp. 117–118.

[6] De Paula, F. R. M., *Accountant,* Jan. 1, 1927, p. 31.

[7] A text especially designed for students of accounting at the university is *Accounting* by S. W. Rowland and B. Magee, London, Gee and Co., 1936, pp. 445 covering: nature of business transactions; theory of double entry; goods account and trading account, expenses and prepayments; bad debts and depreciation; discounts and returns; bills of exchange; final accounts, books-of-original entry; sectional balancing; suspense accounts; receipts-and-payments and income-and-expense accounts; partnership accounts; branch and departmental accounts; consignments; joint-stock companies; royalties; packages; capital and revenue; depreciation; trading and manufacturing accounts; cost accounting; budgetary control; internal check and audit; reserves and sinking funds; secret reserves. It is accompanied by a book of problems.

[8] The outstanding texts on auditing are Dicksee, L. R., *Auditing,* 15 edition by S. W. Rowland, Gee and Co., 1933, pp. 1132; De Paula, F. R. M., *Principles of Auditing,* Pitman, 1937, pp. 338; Taylor, E. M. and Perry, C. R., *Auditing,* Textbooks Ltd., 1935, pp. 307; Cutforth, A. E., *Audits,* Gee and Co., 1931, pp. 340; Lancaster, Joseph, *Principles and Practice of Auditing,* Gregg, 1935, pp. 459; Spicer, E. E. and Pegler, C. E., *Practical Auditing,* London, HFL Publishers Ltd., 1933, pp. 616; Williams, R. G., *Elements of Auditing,* Gregg, 1934, pp. 241.

ing for some fifty years but I cannot trace that it has yet made a substantial contribution to economic science over its own field of analysis of the results of industry although it has practically a monopoly grip of the required data. . . . Accountants have the figures; other people cannot use them and if accountants will not then we get nothing; economics continues its abstract declarations and business blunders on by individual instinct."[9] Recently the Accounting Research Association has been organized, both Chartered and Incorporated Accountants, as well as economists, coördinating its activities. It promotes research in the history and development of accounting and attempts to discover the effect of economic, social and legal changes on accounting techniques. It also examines the present position of accounting theory and practice.[10]

Training for the profession of accountancy in England today is largely based upon the learning of a routine through contact with practical situations. Three types of young people enter the profession: 1. those who have been to a public school (corresponding roughly to the American high school); 2. those who have not been to a public school; 3. those who have obtained a university degree. At any time after sixteen years of age an individual may become articled to a firm of accountants. That is to say, he may enter into an apprenticeship which continues for five years unless he is a university graduate in which case his period of service is reduced to three years. Articles for Chartered Accountants need not follow a specified form as must those of Incorporated Accountants. In both cases they may be transferred and assigned but they must be registered within one month of execution with the Council.

Each practicing accountant is allowed two articled clerks. In most instances a premium is paid by the individual to the firm to whom he is articled. This fee ranges from 100 to 300 guineas (approximately \$525–\$1575) depending on the prestige of the firm.[11] The premium system has been severely criticized and it has been suggested either that premium should be completely prohibited or that a board of control should be set up by the organization with the duties of granting of the premium to the principal taking the pupil and approving of the person named as pupil.[12] Before employment under the articles commences a preliminary examination must be passed by the candidate. This examination for the Institute covers English, arithmetic, algebra, geometry, geography, history and two of the following optional subjects one of which must be a language: Latin, Greek, French, German, Italian, Spanish, Advanced Mathematics, Physics, Chemistry, Geology, Stenography.[13] The preliminary examination for the Incorporated Accountants comprises: general knowledge including history and geography; English including 1. an essay and 2. general English comprising a précis or paraphrase, writing a letter and practical English; foreign language—paper on French, German and Spanish or Latin (unseen translation into English, easy translation from English, free composition); mathematics—arithmetic, algebra, and geometry. This is considered to be a general cultural examination and the candidate may secure a list of the books to be covered by it.

After one-half of the Institute articles

[9] Stamp, Sir Josiah, *Studies in Current Problems in Finance and Government*, London, P. S. King and Son, Ltd., 1924, pp. 16–20.

[10] *Accountant*, Nov. 28, 1936, pp. 730–731; report of first annual meeting, *Accountant*, Feb. 19, 1938, pp. 265–266.

[11] England, Ministry of Labour, Choice of Career Series, #6 Accountancy, 1936, pp. 19.

[12] Gardiner, F. J. B., "The Training of the Articled Clerk," *Accountant*, Nov. 17, 1928, pp. 654–656.

[13] Institute of Chartered Accountants in England and Wales, List of Members 1937, pp. 58–69.

(2½ yrs. for non-university graduates; 1½ yrs. for university graduates) or after 2 years of the Incorporated articles (one year for university graduates) have been completed the articled clerk sits for his intermediate examination. This covers for the Institute the following subjects: bookkeeping and accounts (including limited companies); bookkeeping and accounts (including partnership); bookkeeping and accounts (including executorship); auditing; general commercial knowledge. For the Incorporated Accountants the examination covers: bookkeeping and accounts (including partnership), executorship accounts and income tax; cost accounts; general commercial knowledge; commercial law, powers and duties of liquidators, trustees, executors and receivers. The final Institute examination occurs two years after the intermediate except for university graduates in whose case it is one year. It consists of examination in the following subjects: advanced bookkeeping and accountancy (including limited companies); advanced bookkeeping and accountancy (including partnership and law relating thereto); advanced bookkeeping and accounts (including executorship and law relating thereto); auditing, general financial knowledge (including taxation, costing and foreign exchanges); Company Law (including liquidations); law relating to bankruptcy, deeds of arrangement, receiverships and trusteeships; mercantile law and law of arbitrations and awards. The Incorporated final examination occurs within the last year of the articles, or the last six months if applicable to a university graduate, and it covers advanced accounting (including partnership and executorship accounts and income tax); auditing and general duties of professional accountants (including income tax); cost accounts; general knowledge in relation to commerce and finance; law relating to joint stock companies and bankruptcy; mercantile law (including partnership law and law of arbitration and awards); powers and duties of liquidators, trustees, executors and receivers; statistical methods; economics.

The percentage of success in the three examinations is illustrated by data supplied by the Society of Incorporated Accountants and Auditors[14] and this is taken as typical pass-failure experience of the profession as a whole:

	Final Examination			*Intermediate Examination*			*Final Examination*		
Year	*No. Cand.*	*Passed*	*Failed*	*No. Cand.*	*Passed*	*Failed*	*No. Cand.*	*Passed*	*Failed*
1934	794	46%	54%	973	50%	50%	239	51%	49%
1936	753	49%	51%	927	49%	51%	237	47%	53%

One of the most difficult educational problems is the providing of instruction for articled clerks. Most clerks enter articles with no accounting education; even the university graduates as a whole have taken no business subjects except possibly economics. Coaching courses provide instruction and tutorial colleges offer private oral tuition, class oral tuition, courses or lectures, correspondence courses, or some combination of the foregoing. It is probable that four-fifths of the accountants prepare for their examinations at tutorial colleges. Students' societies function in various English cities but Institute articled clerks are not required to belong to them nor is attendance at meetings compulsory. Incorporated clerks are required to join a students' society within three months after passing the preliminary

[14] 1938 *Yearbook of Society of Incorporated Accountants and Auditors*, p. 1204.

examination but attendance at meetings is optional. F. J. B. Gardiner has suggested that during the first six months of articles the candidate should attend elementary classes in bookkeeping and economic organizations conducted by the local students' society or by tutorials. Other suggestions have also been made: no one should be eligible for articles until the age of 19 has been reached; no one should be articled until he has passed an examination in the theory of bookkeeping and accounts, in general commercial knowledge and in one foreign language; the term of articles should not be less than three years; during the articles two examinations should be given—the last one a practical one (after passing this examination the individual becomes a Chartered Accountant); the Institute should regulate the training of an articled clerk and withhold clerks from firms which do not possess suitable facilities; the system of premiums should be modified or eliminated; a certificate entitling the clerk to practice as a Chartered Accountant should be withheld until he attains the age of 25.[15] A former president of the Society of Incorporated Accountants and Auditors has declared that future possibilities might include the intensification of the work of branch, district and students' societies; a course of study to be pursued prior to the articles followed by an examination in some of the professional subjects; a more definite plan for preparing clerks for examinations on the theoretical side either by means of coöperation with the universities or by the formation of a school of accountancy by the profession itself; the providing of facilities for specialized study and experience after the candidate has been qualified.[16] Lord Plender believes that after leaving the public school or the university the candidate might take a three to six months' course in the fundamental principles of accountancy and that post-graduate courses in accountancy might well be given in the university during regular terms or during the long summer holidays.[17]

The system of education for the accounting profession in England, therefore, consists of a general education on the part of the candidate, the passing of a preliminary examination, training under articles in the office of a Chartered or an Incorporated Accountant, membership in a students' society where lectures, the reading of papers and discussions occur, study for the intermediate and the final examinations and their passing during and after the period of practical training. The candidate at twenty-one and at the end of articles is eligible to become an Associate. Women have been allowed to become Chartered Accountants since the passage of the Sex Disqualification (Removal) Act of 1919 and Incorporated Accountants a little earlier.

The individual entering the English accountancy profession is presumed to be one of cultivation and the training afforded him is considered not only to fit him for his professional duties but to give him the proper ethical standards and outlook toward his work in its relation to the profession and to society. Yet it is undoubtedly true that mediocre men enter the profession and that boys are articled at the early age of sixteen because their parents or guardians wish them to become professional men and not because the boys themselves desire to become accountants. The preliminary examination is thought to be on a par with the matriculation examination of the University of London but below that for the first division of the

[15] Spicer, E. E., "Education for the Accountancy Profession," *Accountant*, July 24, 1926, pp. 129–134.

[16] Keens, Thomas, "Legislation and Education for the Accounting Profession in England," *Accountant*, Oct. 26, 1929, pp. 501–504.

[17] Plender, Lord, *Accountant*, Oct. 26, 1929, pp. 504–505.

English civil service; the standards of the intermediate and final examinations are high but passes may be secured by cramming. With more people constantly attracted to the profession it is essential that the highest standards of entrance be maintained and it has been suggested that the minimum level of general education to be required by the Institute before articles are granted should be a good second class honors degree from one of the universities; that the preliminary examination should be eliminated, with the Institute grouping firms according to the type of work undertaken and students rotated for experience; that the standard of training and its control should be vested in the Institute. Under such a plan the theoretical training would be controlled by the Institute, three years being required for articles which would include four months devoted to theoretical training, with articles requiring that each pupil should become a member of a local students' society with compulsory attendance at lectures and courses.[18]

The *Accountant*, the official organ of the Institute, has printed many letters in its columns of correspondence all emphasizing the need for revision of the system of articles which has been in force for over fifty years.[19] They stress the routine undergone by articled clerks and the cramming for examinations. Running of errands sometimes consumes the first six months of service, while the next period is frequently devoted to checking postings.[20] A recent series of articles on the advantages and disadvantages of university training for accountants written by articled clerks with and without degrees are interesting—the university graduates stress the routine, the monotony, the pettiness of the work but defend the training from the angles of exercise of judgment, making of decisions and development of principles and their application.[21] Eventually it may be that a university degree, such as the Bachelor of Commerce, will be required for entrance as an articled clerk. Exemption from a period of the articles for university graduates might be given only in the event that the clerk had taken economics or accounting courses at the university. Perhaps F. R. M. De Paula's suggestion that there should be a division of time during the articles between specially constructed and supervised university courses and practical work with Chartered Accountants should be followed.[22] Under this scheme never less than one continuous year in the office would occur. "It is difficult to avoid the inference that the want of proper facilities for theoretical training is in part responsible for the scanty interest displayed by accountants in the study of their craft."[23] In far too many cases the Chartered or Incorporated Accountant does not ascertain whether or not his articled clerks are profiting by the experiences afforded them by accounting routine, by lectures, by students' societies and by tutorials.

In the future the profession must assume a more active interest in the education and training of its articled clerks through a thorough examination of the system deciding whether a university degree should be a pre-requisite for articles, revising the examinations given with decreased emphasis upon bankruptcy and increased attention to economics and statistics, revitalizing the work of students' societies and providing some method of instruction in accounting during

[18] Spicer, E. E., "The Articled Clerk in Relation to Education," *Accountant*, March 26, 1927, pp. 465–469.

[19] See for example, *Accountant*, Aug. 3, 1929, p. 146; Aug. 24, 1929, p. 235; Sept. 7, 1929, pp. 292–3; Sept. 14, 1929, p. 321.

[20] *Accountant*, Sept. 21, 1929, p. 349.

[21] *Accountant*, March 5, 1938, pp. 312–3; Feb. 19, 1938, pp. 249–50; Feb. 12, 1938, pp. 218–9.

[22] *Accountant*, March 9, 1929, pp. 285–7.

[23] Carr-Saunders, A. M. and Wilson, P. A., *The Professions*, Oxford, Clarendon Press, 1933, pp. 223–227.

articles. Clearly there is room for greater coördination of the endeavors of the Institute, the Society, and the English universities relative to the devising and teaching of accounting courses. The Society's procedure of offering a week of summer lectures for young accountants at either Oxford or Cambridge is to be commended. An important problem is presented by the fact that twice as many Institute associates are not in practice as are in practice as principals. It is probable that the majority of individuals not in practice are engaged in other occupations than accountancy.[24] It is evident that many men acquire the training for entrance as associates in the Institute and use the title as an entree to a business position. The time and effort devoted to the training of these individuals fails to enrich the profession by the infiltration of new blood as they do not remain in practice at the conclusion of articles.

Routine learning is now emphasized by the English system—and the routine is that of accounting processes rather than of accounting technique and interpretation of economic data. It is interesting to note that economics is an optional subject in the examinations of the Institute although it has been required by the Society as part of the final examination since 1920. English bank clerks who take the examinations of the Institute of Bankers sit for an examination in general economics in the first part and an examination in economics with special reference to currency, taxation and trade cycles in the second part.[25] It seems logical that economics should be made one of the required subjects in the Chartered Accountants' examinations as business tends to become increasingly complex and accounting more involved in its procedure and more concentrated upon its interpretation of economic processes.

In England the happy combination of accounting theory and practical experience as the background for a professional career can only be reached through a critical attack upon the whole subject of education and training of articled clerks. The future should see less emphasis placed upon the routine processes of accounting and auditing, and more attention given to the enlargement of professional and ethical viewpoints.

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[24] List of members of Institute 1937: fellows in practice 2186; fellows not in practice 171; associates in practice 2822; associates not in practice 5763; fellows not in England and Wales 24; associates not in England and Wales 1118; total 12084. An articled clerk becomes an associate after passing all examinations and serving his articles; an associate becomes a fellow after being continuously in practice as a public accountant for five years preceding his application. Incorporated Accountants 1937: fellows 1524; associates 5689; honorary members 3; total 7216-with no differentiation as to in and not in practice.

[25] Jones, T. H., "Professional Training," *Accountant*, July 12, 1930, pp. 42–44.

PROFESSIONAL EXAMINATIONS

A Department for Students of Accounting

HENRY T. CHAMBERLAIN

THE FOLLOWING problems, presented as the first half of the C.P.A. examination in accounting theory and practice, were prepared by the Board of Examiners of the American Institute of Accountants. The examinations were held in the many cooperating states on November 17th and 18th, 1938. Candidates were required to solve all problems and the following weights were given: problems 1 and 2, 30 points each; problem 3, 25 points; problem 4, 15 points.

No. 1

The following trial balance of the Atlantic Seaboard Lumber Company, dated December 31, 1937, is submitted:

	Dr.	*Cr.*
Cash in banks and on hand	$ 45,900	
Accounts receivable—customers	75,650	
Reserve for freight allowances		$ 4,300
Reserve for doubtful accounts		3,500
Standing timber—Tract 1	1,200,000	
Standing timber—Tract 2	500,000	
Reserve for depletion—Tract 1		70,500
Lumber inventory, December 31, 1937	80,000	
Logs in pond, December 31, 1937	1,250	
Material and stores inventory, December 31, 1937	7,500	
Land	5,000	
Buildings and structures	47,000	
Machinery and equipment	140,000	
Transportation equipment	175,000	
Reserve for depreciation		28,710
Prepaid insurance and taxes	4,310	
Accounts payable		11,850
Accrued wages		4,750
Capital stock—6 per cent preferred, noncumulative, $100 par		1,200,000
Capital stock—common, $5 par		900,000
Sales of lumber		565,000
Manufacturing cost of lumber sold	398,000	
Shipping expenses of finished lumber	50,000	
Selling expenses	30,500	
General and administrative expenses	28,500	
	$2,788,610	$2,788,610

The company began business on January 1, 1937, with a capital of $2,100,000 representing cash received for 12,000 preferred shares of $100 each and 180,000 common shares of $5 each. Two uncut timber tracts and the necessary land, buildings and equipment to carry on a lumber business were purchased. An independent cruise showed an estimate of 400,000,000 and 250,000,000 board feet (log scale) on tracts 1 and 2 respectively as available for cutting.

The company valued its closing inventories of finished lumber and logs in pond at average cost per thousand feet produced during the year, irrespective of grades. These inventories, the production for the year and the selling prices per thousand feet prevailing during the year are shown, as follows:

Grade	M Feet Board Measure *Inventory*	M Feet Board Measure *Production*	Selling Price per M Feet
A	600	7,200	$35
B	500	6,000	30
C	400	4,800	25
D	1,600	3,600	20
E	600	1,800	15
F	300	600	10
	4,000	24,000	
	M Feet Log Scale		
Logs in pond	100	23,500	

Material and stores were correctly valued at the lower of cost or market.

The company used 100,000 feet of its grade D lumber in the building of a storehouse and charged $2,000 to building and structures account.

The following cost data on the year's operations were extracted from the records:

		Per M Feet Log Scale	M Feet	
Logging operations:			23,500	Log scale
Stumpage	$ 70,500	$ 3.00		
Cutting	47,000	2.00		
Skidding	23,500	1.00		
Spur tracks	23,500	1.00		
Railroad operation	47,000	2.00		
	$211,500	$ 9.00		
Loading operations:				
Loading to lighters	$ 23,500	$ 1.00		
Towing to mill	58,750	2.50		
	$ 82,250	$ 3.50		
	$293,750	$12.50		
Less—Logs in pond 12/31/37	1,250		100	Log scale
	$292,500		23,400	Log scale
Over-run on basis of actual board measure	....		600	
Cost of logs to sawmill	$292,500	$12.1875	24,000	Board measure
Mill operations:				
Unloading at mill	$ 31,500	$ 1.3125		
Sawmill	96,000	4.00		
Sorting shed	24,000	1.00		
Lumber yard	36,000	1.50		
	$187,500	$ 7.8125		
Total cost of production	$480,000	$20.0000	24,000	Board measure

The reserves for freight allowances and doubtful accounts appear adequate, the fixed-asset accounts have been verified, adequate depreciation has been provided, and all ascertainable liabilities outstanding at December 31, 1937, had been brought upon the books as of that date.

Prepaid insurance and taxes include a charge of $2,500 representing the year's real-estate taxes applicable to tract No. 2.

Logging operations will not commence on this tract until several years hence.

From the foregoing information, prepare:

1. A balance-sheet as at December 31, 1937, showing the closing inventory of finished lumber valued by apportioning the production costs to the several grades on the basis of their sales values.
2. A statement of profit and loss for the year ended on that date.

State briefly why the aforestated method of inventory valuation should be used. Income-tax features in connection with this problem are to be ignored.

No. 2

The Portland Cement Company proposes to acquire all of the outstanding stock of the Industrial Cement Company. An investigation of the fixed assets by independent engineers shows that the land, buildings and equipment are conservatively valued. However, the rock deposits which were depleted on the basis of 60,000,000 tons commercial quantity should have been depleted on the basis of 30,000,000 tons. Up to the end of the year 3,000,000 tons of rock had been quarried.

The inventory is correct as to quantities, and the Industrial Cement Company's cost system determines the cost of the raw materials and finished cement on the basis of the previous month's inventory valuation plus the current month's production cost. This method resulted in high inventory valuation for the reason that during the last three months of the year production was materially curtailed and extensive repairs were made. The Industrial Cement Company agrees that the opening as well as the closing inventories are to be revalued on the basis of the year's production cost and that an adjustment of the depletion reserve should be made.

The Portland Cement Company submits the following December 31, 1937, balance-sheet of the Industrial Cement Company:

Assets

Current assets:		
Cash		$ 500,000
Notes and accounts receivable—less $45,000 reserve		200,000
Inventories:		
Materials and supplies	$ 180,000	
Cement in process and in bins	202,500	382,500
Total current assets		$1,082,500
Fixed assets:		
Buildings and equipment—less $1,000,000 reserve	$2,000,000	
Land	7,500	
Rock deposits—less $30,000 reserve	570,000	
Total fixed assets		2,577,500
Deferred charges		50,000
Total		$3,710,000

Liabilities

Current liabilities		$200,000
Capital:		
Capital stock	$2,800,000	
Earned surplus	710,000	3,510,000
Total		$3,710,000

In addition to the above balance-sheet the following information is given:

	Inventories			
	January 1, 1937		December 31, 1937	
	Quantity	*Amount*	*Quantity*	*Amount*
Rock—tons	20,000	$ 7,000	10,000	$ 5,000
Slurry—bbls	16,000	6,400	10,000	7,500
Clinker	40,000	36,000	70,000	70,000
Cement	70,000	77,000	100,000	120,000
Total		$126,400		$202,500

The departmental production cost for the year ended December 31, 1937, including depreciation and depletion, is as follows:

Rock	$ 60,000
Slurry	158,100
Clinker	530,000
Finish grind	206,000
Total	$954,100

The Industrial Cement Company sold during the year 1,000,000 barrels of cement. It has been that company's experience to obtain 3.4 barrels of cement out of each ton of rock.

The rock is transferred to the slurry, the slurry to the clinker and the clinker to the finish grind, producing cement.

Prepare:

1. A work sheet showing computations.
2. A comparative statement showing the departmental production costs (1) per books and (2) adjusted to the revalued inventories.
3. A computation of the adjusted book value of the common stock of the Industrial Cement Company.

No. 3

On January 1, 1936, Dr. John Smith and Dr. David Jones formed a co-partnership to be known as Drs. Smith and Jones, Physicians and Surgeons. The firm succeeded to the practice which had heretofore been conducted by Dr. Smith as an individual. The only assets acquired by the firm from Dr. Smith were certain furniture and fixtures which by mutual agreement were valued at $3,000.

The partnership agreement provides:

1. For the year 1936 the profits and losses shall be shared in the ratio of 64% to Dr. Smith and 36% to Dr. Jones. Each year thereafter Dr. Jones' share in the firm's profits and property increases 1% until a 50% interest is reached.
2. Dr. Smith is to receive an annual payment for furniture, fixtures and equipment contributed by him to the firm equal to the depreciation thereon.
3. The accounts are to be kept on a cash basis and immediately after the close of each calendar year an accounting is to be made of the preceding year's affairs on said cash basis; each partner is to receive in cash, to the extent available, his distributive share of the net income.

The following condensed trial balances are submitted:

	December 31, 1936		December 31, 1937	
	Dr.	*Cr.*	*Dr.*	*Cr.*
Cash	$ 4,510		$ 4,220	
Accounts receivable—patients	10,000		8,000	
Contingent professional income		$10,000		$ 8,000
Furniture and fixtures—Dr. Smith	3,000		3,000	
Furniture and fixtures—firm	1,200		3,700	
Reserve for depreciation—Dr. Smith		300		300
Reserve for depreciation—firm		60		60

	December 31, 1936 *Dr.*	December 31, 1936 *Cr.*	December 31, 1937 *Dr.*	December 31, 1937 *Cr.*
Dr. Smith—Personal capital		3,000		2,700
Dr. Smith—Fixed capital		768		768
Dr. Smith—Current account		2,176	12,600	
Dr. Jones—Fixed capital		432		432
Dr. Jones—Current account		1,974	6,000	
	$18,710	$18,710		
Professional income				39,000
Total expenses			13,740	
			$51,260	$51,260

Depreciation on furniture and fixtures is to be computed at the rate of 10% per annum; additions during the year on an average of six months. No interest on partners' balances or drawings is to be considered.

From the foregoing data prepare:

1. The entries adjusting the accounts and distributing the cash.
2. The usual columnar work sheet showing the trial balance after the December 31, 1937, final settlement.

No. 4

On October 1, 1928, the Lee Publishing Company entered into a special royalty contract for the publication of a book on a religious subject, the royalty of $40 a hundred to be paid on or before October 1, 1934, on a minimum publication of 50,000 copies. It was stipulated that in the interval the payments were to be made from time to time as the books were bound and ready for sale. The publishing company proceeded to print the minimum number of sheets and included the royalty in the sheet cost, setting up the liability therefor. Up to October 1, 1934, the royalty had been paid as agreed on the basis of 13,500 copies bound, and the balance on the remaining 36,500 copies became due.

However, owing to the slowness of the sale of the book, it was agreed on the latter date that the original contract was to be modified for the balance of the royalties and negotiations commenced to fix the new terms. The publishing company, having on hand 2,840 copies of bound stock, then also decided to write off against its surplus all the royalty included in its inventories.

During the years 1935 and 1936 there were 1,300 additional copies sold and on December 31, 1936, there remained in the hands of the publisher 1,540 bound copies, but no further sheet stock had been bound. On that date a final arrangement was made whereby the remaining royalty liability was settled and paid at 50 cents on the dollar. Thereupon the publishing company, in view of a revived demand for the publication, reinstated as a deferred charge the advance royalty actually paid on the stock in hand.

1. Submit a summary of royalty liability account showing the above transactions and the final settlement.
2. Submit the journal entry recording the adjustment of October 1, 1934, inventories.
3. Submit the journal entry setting up the advance royalty at December 31, 1936, as a deferred charge.

Solution to Problem 1—

Grade	Total Production	Selling Value of Production: Per M feet	Selling Value of Production: Total	Costs Apportioned: Cost per $1 of Sales Value	Cost of Production	Cost of Inventory	Building Cost	Cost of Sales
A.....	7,200 M feet	$35.00	$252,000.00	.7305936	$184,109.59	$15,342.47		$168,767.12
B.....	6,000	30.00	180,000.00	.7305936	131,506.85	10,958.90		120,547.95
C.....	4,800	25.00	120,000.00	.7305936	87,671.23	7,305.94		80,365.29
D.....	3,600	20.00	72,000.00	.7305936	52,602.74	23,378.99	$1,461.19	27,762.56
E.....	1,800	15.00	27,000.00	.7305936	19,726.03	6,575.34		13,150.69
F.....	600	10.00	6,000.00	.7305936	4,383.56	2,191.78		2,191.78
	24,000 M feet		$657,000.00		$480,000.00	$65,753.42	$1,461.19	$412,785.39

Adjusting Journal Entries

(1)

Manufacturing cost of lumber sold....................	$14,785.39	
Lumber inventory, December 31, 1937.............		$14,246.58
Buildings and structures.........................		538.81
To adjust the above accounts in accordance with the schedule given above.		

(2)

Standing timber—Tract 2..........................	$ 2,500.00	
Prepaid insurance and taxes......................		$ 2,500.00
To capitalize real estate taxes on Tract 2.		

Seaboard Lumber Company
Balance Sheet
December 31, 1937

Assets

Current assets				
Cash in banks and on hand............................			$ 45,900.00	
Accounts receivable—customers........................		$ 75,650.00		
Less: Reserve for doubtful accounts..........	$3,500.00			
Reserve for freight allowances..........	4,300.00	7,800.00	67,850.00	
Lumber inventory, at cost............................			65,753.42	
Logs in pond, at cost................................			1,250.00	
Material and stores inventory, at the lower of cost or market			7,500.00	
Prepaid insurance and taxes..........................			1,810.00	
Total current assets...............................				$ 190,063.42
Fixed assets				
Standing timber—Tract 1..............................		$1,200,000.00		
Less reserve for depletion...........................		70,500.00	$1,129,500.00	
Standing timber—Tract 2 (Logging operations have not been started on this tract)........................			502,500.00	
Land...			5,000.00	
Buildings and structures.............................		$ 46,461.19		
Machinery and equipment..............................		140,000.00		
Transportation equipment.............................		175,000.00		
Total..		$ 361,461.19		
Less reserve for depreciation........................		28,710.00	332,751.19	
Total fixed assets.................................				1,969,751.19
Total assets.......................................				$2,159,814.61

Liabilities

Current Liabilities		
Accounts payable	$ 11,850.00	
Accrued wages	4,750.00	
Total current liabilities		$ 16,600.00
Capital stock and surplus		
6 per cent, noncumulative preferred stock, par value $100.00 per share, 12,000 shares issued and outstanding	$1,200,000.00	
Common stock, par value $5.00 per share, 180,000 shares issued and outstanding	900,000.00	
Earned surplus	43,214.61	
Total capital stock and surplus		2,143,214.61
Total liabilities		$2,159,814.61

Seaboard Lumber Company
Statement of Profit and Loss
January 1, 1937 to December 31, 1937

Sales of lumber		$565,000.00
Less manufacturing cost of lumber sold		412,785.39
Gross profit on sales		$152,214.61
Less expenses:		
Shipping expenses of finished lumber	$50,000.00	
Selling expenses	30,500.00	
General and administrative expenses	28,500.00	109,000.00
Net profit for the year ended December 31, 1937		$ 43,214.61

In the course of production the various grades of lumber cannot be identified, consequently, it is impossible to identify costs incurred in producing the various grades. The total cost, $480,000.00, is a joint cost of producing all grades and the method used here assumes that a uniform rate of gross profit is made on all grades.

COMMENTS

(1) The costs incurred up to the sawmill operations are based on the log scale and it would be incorrect to adjust these costs for the over-run which became apparent in the sawmill operation. If an adjustment were made it would be necessary to assume that the logs in pond will, when processed in the sawmill, result in the same percentage of over-run. This, of course, would be an unwarranted assumption.

(2) Since operations on tract No. 2 will not commence for several years the taxes paid on that property are properly regarded as an additional cost of the tract.

Solution to Problem 2—

Computation of Costs

Cement production for year	
Inventory cement, December 31, 1937	100,000 bbls.
Sales, 1937	1,000,000 bbls.
Total sales and inventory	1,100,000 bbls.
Inventory cement, January 1, 1937	70,000 bbls.
Production for year	1,030,000 bbls.

Computation of rock quarried, 1937

Cement production for year		1,030,000 bbls.
Add: Increase in clinker		
Inventory—clinker, December 31, 1937	70,000 bbls.	
Inventory—clinker, January 1, 1937	40,000 bbls.	30,000 bbls.
		1,060,000 bbls.
Deduct: Decrease in slurry		
Inventory slurry, January 1, 1937	16,000 bbls.	
Inventory—slurry, December 31, 1937	10,000 bbls.	6,000 bbls.
Rock used		1,054,000 bbls.

Rock used 1,054,000÷3.4=	310,000 tons
Less: Inventory, January 1, 1937	20,000 tons
	290,000 tons
Add: Inventory, December 31, 1937	10,000 tons
Rock quarried, 1937	300,000 tons

Computation of Depletion Rates

Original cost of rock deposits	$600,000.00
Original estimate of rock deposits	60,000,000 tons
Original depletion rate	.01 per ton
Corrected estimate of rock deposits	30,000,000 tons
Corrected depletion rate	.02 per ton

Computation of rock cost

Cost per books		$ 60,000.00
Add: Corrected depletion	$6,000.00	
Less depletion originally charged	3,000.00	3,000.00
Corrected rock cost		$ 63,000.00
Corrected cost per ton		$.21
Cost per barrel of cement .21÷3.4=		$.061765

Computation of slurry cost

Inventory rock January 1, 1937	20,000 tons
Rock quarried	300,000 tons
	320,000 tons
Inventory rock December 31, 1937	10,000 tons
Transferred to Slurry Department	310,000 tons
310,000 tons rock produced 1,054,000 barrels of slurry at 3.4 barrels per ton.	
Total costs incurred in Slurry Department	$158,100.00
Unit cost $158,100÷1,054,000=	.15

Computation of clinker cost

Inventory slurry, January 1, 1937	16,000 bbls.
Total slurry produced 1937	1,054,000 bbls.
	1,070,000 bbls.
Inventory slurry, December 31, 1937	10,000 bbls.
Transferred to Clinker Department	1,060,000 bbls.
Total costs incurred in Clinker Department	$530,000.00
Unit cost, $530,000÷1,060,000=	$ .50

Computation of grinding cost

Inventory clinker, January 1, 1937	40,000 bbls.
Total clinker produced, 1937	1,060,000 bbls.
	1,100,000 bbls.
Inventory clinker, December 31, 1937	70,000 bbls.
Total clinker ground 1937	1,030,000 bbls.
Unit cost, $206,000÷1,030,000=	$ .20

Unit inventory values, December 31, 1937

Rock, per ton		$.21
Slurry per barrel		
Rock cost	$.061765	
Departmental cost	.15	$.211765
Clinker, per barrel		
Slurry cost	$.211765	
Departmental cost	.50	$.711765
Finished cement, per barrel		
Clinker cost	$.711765	
Departmental cost	.20	$.911765

Adjusted values of January 1, 1937 Inventory

Rock	20,000 tons @ $.21 per ton	$ 4,200.00
Slurry	16,000 bbls. @ $.211765 per bbl.	3,388.24
Clinker	40,000 bbls. @ $.711765 per bbl.	28,470.60
Cement	70,000 bbls. @ $.911765 per bbl.	63,823.55
		$ 99,882.39

Adjusted values of December 31, 1937 Inventory

Rock	10,000 tons @ $.21 per ton	$ 2,100.00
Slurry	10,000 bbls. @ $.211765 per bbl.	2,117.65
Clinker	70,000 bbls. @ $.711765 per bbl.	49,823.55
Cement	100,000 bbls. @ $.911765 per bbl.	91,176.50
		$145,217.70

Comparative Statement Showing the Departmental Production Costs
(1) per Books and (2) Adjusted to Inventory Values
Quarry Department

	Production tons	*Costs per books*	*Adjusted costs*
Inventory January 1, 1937	20,000	$ 7,000.00	$ 4,200.00
Rock depletion, 1937	300,000	3,000.00	6,000.00
Other departmental costs		57,000.00	57,000.00
Total production costs	320,000	$ 67,000.00	$ 67,200.00
Inventory, December 31, 1937	10,000	5,000.00	2,100.00
Transferred to Slurry Department	310,000	$ 62,000.00	$ 65,100.00
Unit cost of rock		$ .20	$ .21

Slurry Department

	Production barrels	Costs per books	Adjusted costs
Inventory, January 1, 1937	16,000	$ 6,400.00	$ 3,388.24
Transferred from prior department	1,054,000	62,000.00	65,100.00
Departmental costs		158,100.00	158,100.00
Total production costs	1,070,000	$226,500.00	$ 226,588.24
Inventory, December 31, 1937	10,000	7,500.00	2,117.65
Transferred to Clinker Department	1,060,000	$219,000.00	$ 224,470.59
Unit cost of slurry		$ .206604	$ .211765

Clinker Department

	Production barrels	Costs per books	Adjusted costs
Inventory, January 1, 1937	40,000	$ 36,000.00	$ 28,470.60
Transferred from prior department	1,060,000	219,000.00	224,470.59
Departmental costs		530,000.00	530,000.00
Total production costs	1,100,000	$785,000.00	$ 782,941.19
Inventory, December 31, 1938	70,000	70,000.00	49,823.55
Transferred to Grinding Department	1,030,000	$715,000.00	$ 733,117.64
Unit cost of clinker		$ .694175	$ .711765

Finish Grind Department

	Production barrels	Costs per books	Adjusted costs
Inventory, January 1, 1937	70,000	$ 77,000.00	$ 63,823.55
Transferred from prior department	1,030,000	715,000.00	733,117.64
Departmental costs		206,000.00	206,000.00
Total production costs	1,100,000	$998,000.00	$1,002,941.19
Inventory, December 31, 1937	100,000	120,000.00	91,176.50
Cost of cement sold	1,000,000	$878,000.00	$ 911,764.69
Unit cost of cement sold		$ .878	$ .911765

Computation of Adjusted Book Value of the Common Stock of the Industrial Cement Company

Book value before adjustment			
Total assets			$3,710,000.00
Total liabilities			200,000.00
Book value of common stock			$3,510,000.00
Adjustments			
Addition to reserve for depletion of rock deposits		$30,000.00	
Adjustment of inventory values, December 31, 1937:			
Book inventory	$202,500.00		
Adjusted inventory	145,217.70	57,282.30	87,282.30
Adjusted book value, common stock			$3,422,717.70

COMMENTS

In the above solution it was assumed that:

(a) The inventories in each department, both at the beginning and end of the year, were completely processed in the departments in which they are located.

(b) The departmental production costs, as given in the problem, do not include the opening inventories.

Solution to Problem 3—

Dr. Smith and Dr. Jones
Working Trial Balance
December 31, 1937

	Trial Balance December 31, 1937		*Transactions and Adjustments*		*Balance Sheet December 31, 1937*	
	Debit	*Credit*	*Debit*	*Credit*		
Cash	$ 4,220.00			(7) $ 3,920.00 (6) 300.00		
Accounts receivable—patients	8,000.00				$ 8,000.00	
Contingent professional income		$ 8,000.00				$ 8,000.00
Furniture and fixtures—Dr. Smith	3,000.00				3,000.00	
Furniture and fixtures—firm	3,700.00				3,700.00	
Reserve for depreciation—Dr. Smith		300.00		(1) 300.00		600.00
Reserve for depreciation—firm		60.00		(1) 245.00		305.00
Dr. Smith—Personal capital		2,700.00	(6) $ 300.00			2,400.00
Dr. Smith—Fixed capital		768.00	(4) 11.40	(5) 1,382.25		2,138.85
Dr. Smith—Current account	12,600.00		(7) 1,588.20 (5) 1,382.25	(3) 15,570.45		
Dr. Jones—Fixed capital		432.00		(5) 812.75 (4) 11.40		1,256.15
Dr. Jones—Current account	6,000.00		(7) 2,331.80 (5) 812.75	(3) 9,144.55		
Professional income		39,000.00	(2) 39,000.00			
Total expenses	13,740.00			(2) 13,740.00		
	$51,260.00	$51,260.00				
Depreciation			(1) 545.00	(2) 545.00		
Profit and loss			(3) 24,715.00	(2) 24,715.00		
			$70,686.40	$70,686.40	$14,700.00	$14,700.00

(1)

Depreciation		$ 545.00	
Reserve for depreciation—Dr. Smith			$ 300.00
Reserve for depreciation—firm			245.00
To record depreciation for the year, 1937:			
Asset contributed by Dr. Smith—10% of $3,000.00	$300.00		
Firm assets:			
Balance, January 1, 1937—10% of $1,200.00	120.00		
Purchased in 1937—5% of $2,500.00	125.00		
Total	$545.00		

(2)

Professional income	$39,000.00	
Expenses		$13,740.00
Depreciation		545.00
Profit and loss		24,715.00

To close income and expense accounts.

(3)

Profit and loss	$24,715.00	
Dr. Smith—Current account		$15,570.45
Dr. Jones—Current account		9,144.55

To distribute net profit to the partners' accounts.

(4)

Dr. Smith—Fixed capital	$ 11.40	
Dr. Jones—Fixed capital		$ 11.40

To adjust the fixed capital accounts as of January 1, 1937 to an amount equal to 63% for Dr. Smith and 37% for Dr. Jones of the net value of fixed assets at that date.

(5)

Dr. Smith—Current account	$ 1,382.25	
Dr. Jones—Current account	812.75	
Dr. Smith—Fixed capital		$ 1,382.25
Dr. Jones—Fixed capital		812.75

To adjust the fixed capital accounts as of December 31, 1937 to the 63–37 ratio:

	Dr. Smith	*Dr. Jones*
Balance—December 31, 1936	$ 768.00	$ 432.00
Adjusting entry 4	11.40	11.40
	$ 756.60	$ 443.40
Equity in firm net fixed assets at December 31, 1937 (63–37)	2,138.85	1,256.15
Adjustment, December 31, 1937	$1,382.25	$ 812.75

(6)

Dr. Smith—Personal capital	$ 300.00	
Cash		$ 300.00

To record payment of cash equal to depreciation on assets contributed.

(7)

Dr. Smith—Current account	$ 1,588.20	
Dr. Jones—Current account	2,331.80	
Cash		$ 3,920.00

To record cash contributed in settlement of current account balances.

Comments

The cash distributed may be accounted for as follows:

			Total	*Dr. Smith*	*Dr. Jones*
Equity in cash balance December 31,					
Amounts equal to current account balances			$ 4,150.00	$ 2,176.00	$ 1,974.00
Amount due Dr. Smith equal to 1936 depreciation on contributed assets			300.00	300.00	
Remaining cash equal to depreciation charged in 1936 on firm assets (64–36 basis)			60.00	38.40	21.60
Cash balance, December 31, 1936			$ 4,510.00	$ 2,514.40	$ 1,995.60
Equity in net cash receipts of 1937:					
Professional income		$39,000.00			
Less: Expenses paid	$13,740.00				
Assets purchased	2,500.00	16,240.00			
		$22,760.00			
Allocation:					
Amount due Dr. Smith equal to 1937 depreciation on contributed assets			300.00	300.00	
Balance in 63–37 ratio ($22,760.00 less $300.00)			22,460.00	14,149.80	8,310.20
			$27,270.00	$16,964.20	$10,305.80
Cash distributions during 1937:					
Drawings against current account			$22,750.00	$14,776.00	$ 7,974.00
Payment to Dr. Smith equal to 1936 and 1937 depreciation charges on contributed assets			600.00	600.00	
Current account balance paid (Journal Entry 7)			3,920.00	1,588.20	2,331.80
			$27,270.00	$16,964.20	$10,305.80

Solution to Problem 4—

1. *Royalty liability*

Total contract liability (50,000 units at $40.00 per hundred)	$20,000.00
Royalties paid up to October 1, 1934 (13,500 units at $40.00 per hundred)	5,400.00

Unpaid balance on October 1, 1934 (36,500 units)		$14,600.00
Reduction in liability on December 31, 1936		7,300.00
Balance paid December 31, 1936 (36,500 units at $20.00 per hundred)		$ 7,300.00

2. Royalty cost included in inventory, October 1, 1934:

Total royalty cost		$20,000.00
Royalty on copies sold:		
Copies bound	13,500	
Bound copies on hand, October 1, 1934	2,840	
Copies sold at $.40	10,660	4,264.00
Total royalty cost in inventory		$15,736.00
Royalty cost in bound inventory (2,840 at $.40)		1,136.00
Royalty cost in sheet inventory (36,500 at $.40)		$14,600.00

The entry made on October 1, 1934 is as follows:

Surplus	$15,736.00	
Inventory of bound stock		$ 1,136.00
Inventory of unbound stock		14,600.00
To write-off the royalty cost included in the inventories.		

3. Royalty cost to be set up as a deferred charge on December 31, 1936:

Royalty paid prior to October 1, 1934 on bound stock now on hand (1,540 units at $.40)	$ 616.00
Royalty actually paid on sheet inventory (36,500 units at $.20 per unit)	7,300.00
Royalties paid on goods in inventory	$ 7,916.00

The entry is as follows:

Deferred royalty expense	$7,916.00	
Surplus		$ 7,916.00
To restore royalty cost previously charged to surplus.		

COMMENTS

The problem states that the inventory was written down on October 1, 1934 by a charge to surplus. Because of this, the royalty cost which was set up on December 31, 1936 was credited to surplus. Both of these entries should have been handled through the profit-and-loss account.

GENERAL COMMENTS

In an examination intended to determine fitness for professional recognition one would expect to find questions designed to disclose a candidate's grasp and perspective of the field of the profession. Apparently these four problems were designed for a different purpose. Nowhere is the candidate required to exhibit his knowledge of the principles which underlie accounting, and as for judgment, none was needed.

Whatever value problem 1 has is completely destroyed by the instructions given to apportion "the production costs to the several grades on the basis of their sales values." Only two possible bases for apportioning the costs are open in this problem and the selection of one of these would result in an absurd solution. Why then should the candidate be told the basis to be used? Should not the examination test the candidate's ability to make a reasonable choice? The value of a problem can be nullified quite as easily by giving too much information as it can by giving an insufficient amount.

Problem 2 is a simple cost problem without interesting points, although a good deal of paper work is required. Problem 3 is a simple partnership problem. Problem 4 is altogether too elementary for a C. P. A. examination.

A suggested time schedule is given below:

Problem 1	75 minutes
Problem 2	90 minutes
Problem 3	60 minutes
Problem 4	30 minutes

BOOK REVIEWS

Corporation Finance. Henry E. Hoagland (New York: McGraw-Hill Book Company, Inc., 1938, pp. xii, 596. $4.00.)

Following the customary discussion of the form of corporate organization in Part I, Professor Hoagland's book proceeds by description through the usual outline of treatment of the subject of corporation finance. The vast variety of security issue forms is emphasized in Part II largely by enumeration and citation of corporate practices with respect to all phases of stock and bond contracts. In Part III, the techniques and institutions contributing to the solution of the problem of raising capital are enumerated and described. In a similar manner, the reader is led through material dealing with practices of corporations in meeting the problems of working capital management and control, dividend, and investment policies (Part IV). Motives and methods of expansion are examined in Part V with special consideration of intercorporate relationships. Corporate readjustments of solvent and insolvent corporations are described in Part VI, and in Part VII, the problem of social control of corporations is considered.

This reviewer happens not to like Professor Hoagland's method of dealing with the subject of corporation finance, because in this text, the author uses the method of listing advantages and disadvantages of each financial practice and institution discussed. For those who wish to cover the field of finance rapidly, this approach may be useful, but it does not encourage analytical thought on the subject. There is little of a net contribution to the literature of the field contained in this book which seems not to fulfill the promise of its preface that "It is founded upon a recognition of the fact that the corporation is a living institution, forever changing because it is subject to the wills of its creators, who in turn respond to changing pressures from many quarters." As a statement of the principles of finance, the text may appeal to those who like the author's readable style and are less concerned with the "Why?" and "So what?" behind the facts which are enumerated.

M. H. Waterman
School of Business Administration
University of Michigan

Speculation, Stock Prices, and Industrial Fluctuations. James A. Ross. (New York: The Ronald Press, 1938, pp. xvi, 426. $4.50.)

This volume represents a study of the place of stock exchanges in our capitalistic economy. A large number of stock market factors are studied, such as speculation and gambling, personnel of the market, stock values, interest rates, margin trading and short selling, manipulations, cycles of business and stock prices, investment and business volume. Each of the important factors has been studied and analyzed in great detail. The analyses are thorough and excellently handled and, in themselves, represent a real contribution to the literature in this field. The main contribution of this work, however, lies in the bringing together of a number of factors which have been studied before as isolated phenomena but are here presented as parts of a whole.

Speculation, the central theme, is treated as helping to create the increasing price structure of a boom period, through margin trading, just as short-selling helps to speed up falling prices in a bear market. In each case, the stock prices that result, at least partly from speculation, have important results on investment, production, and profits. The phenomena of investment, production, profits and stock prices are all interrelated, with changes in the velocity of credit in the financial world having important consequences.

This analysis of speculation makes greater use, as compared with other previous works, of the various cycles to be found in the stock market. The resulting analysis is, in consequence, more precise, and the results which may follow are more clearly stated, than is true of previous attempts.

For a work that covers such a very large field, there are surprisingly few lines of thought which seem open to question. The discussion of the data available, and data needed, to determine the value of securities certainly does not over-emphasize the difficulty of such valuation, but perhaps underrates the data made available under recent legislation. The excellent treatment of margin trading could have been made more valuable by adding a similarly penetrating analysis of the effects of margin regulations since the passage of the Securities Exchange Act. However, such criticisms are of minor importance and refer, for the most part, to other problems in this field which have not been attacked in this volume.

Much of the material used refers, necessarily, to the 1929–33 period, not only because of the importance of this period in any study of stock markets, but also because the Congressional investigations gave us more information for these years than we have for any other comparable period. This information has been well-handled, from the factual point of view and, wherever possible, has been brought up to date. The real importance of this information, however, is not so much in the factual presentation as in the manner in which it has been woven into the theories of speculation and investment.

This whole study is compactly but clearly written, and the arguments and theories are supported by the best of the available statistical data.

Frank P. Smith
University of Rochester

The Causes of Economic Fluctuations. Willford I. King. (New York: The Ronald Press Company, 1938, pp. xv, 353.)

This book covers, and covers well, a much broader field than its title suggests. In addition to causes of business fluctuations it discusses at length the nature of the business cycle and ways of reducing the severity of cyclical swings, with a chapter on forecasting business fluctuations also included. It is an excellent short re-

view of the work which has been done up to date by many investigators in these several areas. It is very useful for the college student and the general reader but does not offer much that is new to the specialist.

According to the author there are three environmental conditions conducive to violent business fluctuations: (1) the mass movement in public sentiment from pessimism to optimism. This generates the boom which in turn leads to the collapse. (2) The existence of a freely expansible credit system. (3) The considerable degree of rigidity in the wage and price structure. Behind these environmental conditions there may be causal factors in the physical realm. Considerable deference is shown to recent investigations tending to suggest that variations in solar radiation may be responsible for variations in pessimism and optimism. Such physical phenomena are, of course, not subject to control but there are also strong factors making for instability which are subject to control. Much attention is given, therefore, to various control procedures. Emphasis is placed upon the necessity for reducing the elasticity of credit and increasing the elasticity of wages and prices. The Government through the Federal Reserve Board should carry on a much more vigorous policy of open market operations in government securities than has heretofore been tried, and contracts between employers and organized labor should be made upon the basis of fixed unit shares in gross income instead of upon a fixed wage basis. Unless such measures are adopted it may prove necessary, in the author's judgment, to follow more drastic programs such as 100 per cent reserves behind bank deposits and the placing upon employers the legal responsibility for stabilizing their production volume and employment. Each of these several procedures is discussed in an illuminating fashion.

Among the procedures which are regarded as ineffective in combatting depressions the author discusses "buy now" campaigns, price advances to stimulate forward-buying, increases in wage rates and work spreading, and spending by the Government.

In a short chapter on business forecasting the complexity and unavoidability of the undertaking is emphasized. Scientific forecasting must be based upon a combination of "empirical" and "logical" methods. The use of past sequences is a form of empirical forecasting while the utilization of all pertinent data and factors is involved in the logical method. Brief attention is given to a few specific forecasting procedures. This chapter is perhaps the least helpful in the book which as a whole brings together a large amount of very useful material.

Joseph L. Snider

Harvard Business School

Federal Tax Practice. Revised Edition. Robert H. Montgomery. (New York: The Ronald Press Company, 1938, pp. xviii, 872. $10.00.)

This is a book on procedure for those actively engaged in tax practice. It is a rather thorough revision of the book which first appeared in 1929 and incorporates changes made by successive Revenue Acts from 1932 through 1938 together with decisions by the Treasury, Board of Tax Appeals, and Federal Courts relating to practice and procedure.

Part I contains 141 pages dealing with practice and procedure with the Treasury Department. It consists of five chapters on (1) Organization and Administration, (2) Determination of Deficiencies, (3) Assessment of Deficiencies, (4) Payment and Collection of Deficiencies, and (5) Credits and Refunds. It gives a full picture of procedure in contacts and negotiations with revenue agents and other Treasury Department representatives.

The United States Board of Tax Appeals is dealt with in the seven chapters of Part II. These various chapters treat of the organization of the board, its jurisdiction, pleading and practice before hearing, preparation for hearing, evidence, practice at hearing, and practice after hearing.

The third section under the heading of Federal Courts opens with three chapters on practice and procedure before the Board of Tax Appeals and the Circuit Courts of Appeals in appealing a Board decision, or in contesting a decision appealed by the Commissioner. Then follow three chapters on suits for refunds before a Federal District Court or the United States Court of Claims. The final two chapters cover appeals to the United States Circuit Courts of Appeals from the District Courts and the review of tax cases by the Supreme Court of the United States.

Pertinent appendices cover 190 pages and the final 81 pages are devoted to various necessary indexes. To this reviewer it seems that practically all necessary steps to be taken in tax practice have been set forth clearly. The reasons for all steps are given by such means as numerous references to laws, regulations, and court decisions. Without such a book, which seems to have been very carefully prepared and to be the result of a tremendous amount of work, only the most experienced could handle tax practice at all satisfactorily.

Arthur W. Hanson

Harvard University
Graduate School of Business Administration

Federal Tax Course. 1939 Edition. (New York: Prentice-Hall Inc. $5.00.)

Alexander Federal Tax Course and Guide, 1939. (New York: Alexander Publishing Company Inc. $10.18.)

The La Salle Manual of Federal Income Tax Procedure, 1938. (Chicago: La Salle Extension University Press, pp. xii, 255.)

Anyone anticipating difficulty in securing texts on Federal taxation which keep abreast of the frequent changes in revenue acts and Treasury regulations must be pleasantly surprised by the amount of satisfactory material available. The adequacy of teaching material is probably the result of the great wealth of information presented in the larger loose-leaf tax services developed to meet the needs of taxpayers, accountants, and attorneys. Two of the tax courses reviewed here are based upon more elaborate current services.

The *Federal Tax Course*, 1939 edition of Prentice-Hall Inc. is in effect, an abridgment of that company's complete Federal Tax Service. One of its chief advantages lies in the opportunity it affords the student of familiarizing himself with one of the standard services

by suggested supplemental reading on selected topics in the full service, if one is available. The *Federal Tax Course* consists of four main parts: (1) an explanation of the law and regulations; (2) a set of problems for solution by the student; (3) the text of the Revenue Act of 1938, with changes from the 1936 and 1937 acts indicated, and the text of other acts still in effect dealing with taxation, including parts of the Revenue Acts of 1926 and 1932 and parts of the Social Security Act; and (4) a reprint of Regulations 94, applicable to the income tax provisions of the Revenue Act of 1936. Provision is made to supply the new regulations to be issued during the winter of 1938–1939, applicable to the Revenue Act of 1938. Cross-reference tables facilitate a comparison of the related sections of the explanation, the laws, and the regulations, and indicate which of the problems for solution require consideration of the different sections of the law and regulations. An additional table gives for each paragraph in the *Federal Tax Course* the paragraph numbers in the Prentice-Hall Tax Service where the same subject is treated in more detail.

The section of explanation contains 30 chapters of from 3 to 28 pages. The sequence of the chapters is perhaps not an ideal one for teaching, but assignments can be made at will to accord with the development preferred. The problems follow roughly the subject matter of the different chapters, with as many as 25 problems for one chapter of explanation. A set of solutions is available for instructors.

It seems altogether desirable that taxation should be taught with frequent reference to the pertinent laws and regulations. To do so gives a better conception of tax law as a changing force in the business and economic world. Likewise, since no set of explanations can cover all problems that will come up in practice, it is helpful to have some working familarity with the law and the regulations.

The *Alexander Federal Tax Course and Guide*, 1939, includes. (1) a text of 385 pages presenting a statement in nonlegal terms of the income tax law, with brief statements on other Federal taxes; (2) a set of 242 problems, with solutions and explanations; (3) reprints of the Revenue Act of 1938 and parts of other statutes currently effective as part of our general tax law; and (4) a reprint of Regulations 94, as amended, applicable to the income tax under the Revenue Acts of 1936 and 1937. The text seems more in the nature of a statement of fact standing by itself than an interpretation of a complicated statute. As such it is quite readable, but a more thorough sense of integration with the law and regulations might be useful. Though specific reference is not made, section by section, to the revenue acts, the text gives good brief historical surveys of some of the changes in tax law over the years. It is to be commended for including this historical background, with its implication of a constantly developing law. All footnotes to the text, referring to related sections of the law and the regulations, to the *Alexander Federal Tax Service*, and to various court decisions and Treasury rulings and decisions are collected together in a single section at the end of the text. It would seem desirable in teaching to make liberal use of the references there indicated.

The section on "Tax Economy" is a desirable one in that it demonstrates how the decisions of business management may be influenced or controlled by tax laws. In the section of problems, the solution following each problem explains the reason for the answer and provides a useful supplement to the text. Specimen tax returns are to be provided when the forms for reporting 1938 incomes are released by the Treasury Department.

The illustrations in the explanation sections of both the Prentice-Hall and Alexander courses are hypothetical. This makes possible simplification to emphasize critical facts, but results in a lack of appreciation of the range and amount of litigation involved in tax matters which is secured from even a casual survey of a complete tax service. It is, however, perhaps impossible to condense actual cases sufficiently to use them as illustrative material in a survey course.

The *La Salle Manual of Federal Income Tax Procedure*, 1938 edition, in 255 pages gives a good working approach to the Federal income tax. The coverage is fairly complete, and the exposition is both clear and concise. Frequent reference is made to individual sections of the law, with quotations of particularly important parts. Illustrations and the material used in specimen returns are well chosen. One who has studied only a straightforward text may find himself unduly baffled when he meets a problem of a type not covered in his text. The use of a copy of the law and the regulations in connection with the Manual might be helpful in lessening this danger. For an introductory survey, however, the manual as it stands serves adequately. The 1938 edition is based on the Revenue Act of 1936, with an additional chapter on the Revenue Act of 1937. The important changes, especially in the taxation of corporations, made in the Revenue Act of 1938 are thus not indicated in the 1938 edition of the manual.

All of the tax courses reviewed here are designed for the important and practical purpose of providing an intelligent approach for compliance with existing tax laws. They do not, and in their limited space cannot, give a critical survey of the effects of those taxes on business practice and our economic structure, nor can they provide an adequate background for balanced judgments on proposed changes in the laws. The economist would do well to familiarize himself in detail with the provisions of the laws as presented in the tax courses, as a necessary preliminary step for any appraisal of the effects of those laws. A teacher of one of the tax courses would, it is hoped, take the opportunity to provide, within the limits of available time, the additional material necessary to permit students to view taxation in its broader aspects as an important factor in our general economy.

Dan Throop Smith

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Government Price-Fixing. Jules Backman. (New York: Pitman Publishing Corporation, 1938, pp. xi, 304. $3.00.)

The steadily increasing amount of governmental interference in what used to be considered strictly private affairs has been a matter of concern to many serious

students of political and economic affairs. The book under review limits itself to a critique of the many price-fixing experiments of recent times on the part of many governments. Dr. Backman does not believe in unrestricted *laissez faire;* neither does he favor any great extension of the powers of government, as the latter leads to business disturbances creating "new problems which are seized upon by the planners to extend government intervention."

Price-fixing may be direct or indirect. If the former, it is concerned with the fixing of a maximum or minimum price or some similar scheme. If the latter, it may take the form of limitation of supply, production control, or marketing control, and all of these and their many ramifications have been tried at one time or another in one country or another. At the end of the war, some 573 commodities were subject to some form of price control by the price section of the War Industries Board, and these commodities in contrast to those left uncontrolled showed much greater price stability. During the days of the N.R.A., we had, of course, price-fixing on a large scale. It may or may not have been the original intention of the framers to fix prices; nevertheless, such fixing took place, both by way of fixing minimum prices, as in the case of prohibitions of sales below cost, and by limiting the available supply. What happened in industry generally is pretty much on a par with what happened in the iron and steel industry. The privilege of fixing prices was exacted as a *quid-pro-quo* for the adoption of the labor provisions contained in the act; and in all these cases it is probably fair to say that the government came off second-best in the argument.

For a long time to come statisticians will probably be busy trying to trace the effects of the A.A.A. program. As the author points out, the increased farm income in 1935 was due in part to the devaluation of the dollar, drought and dust storms which eliminated surplus stocks, and the natural forces tending towards recovery.

Elimination of surplus stocks naturally brings up the discussion of valorization schemes representing attempts to stabilize prices through good and bad years "by regulating the amount of product made available on the market." These schemes have been limited to agricultural products and have always failed. Man-made devices it seems have not yet succeeded everywhere in overcoming the forces of nature.

From the accountant's standpoint, the chapter on cost of production as a basis for price-fixing is of immediate interest. Unfortunately, as every cost accountant knows, cost is a concept of varied meanings. If price is to be fixed on the basis of production cost, several questions must at once be answered. In the first place, even economists admit that price will tend to equal cost of production over a long period of time. But price for the most part is a short-run phenomenon. Again, whose cost is to be used? The cost of the marginal producer, the "normal" producer, to use Marshall's term, the low cost producer, or the cost of each individual producer? If the latter, the provision attempts to guarantee a profit to each producer, but it must fail, since the low cost producer in time will drive the high cost producer out of business. All these problems were met with during the war, when "bulk line" (marginal) costs were used, and during the N.R.A. when different industries adopted different standards of cost determination. The author is well aware of these problems but he can no more than pose the question, since the accountants themselves do not know the answers. Even if we adopt any one of the above suggestions, we still are uncertain as to what must be included in cost of production. Here the accountant and economist apparently do not talk the same language. Profit is included as an element of cost by economists; hence, cost of production in the economists' language must mean total cost, since no profit could arise unless all costs were met. Hence, it seems somewhat pointless to raise an argument as to whether marketing costs should or should not be included in the cost of production. In addition there are economists who have definitely differentiated production and marketing costs, defining the latter as all those costs which change the shape or position of the demand curve.[1]

Every cost accountant is, familiar with the problem of estimated and allocated costs. Where joint costs must be distributed, personal judgment enters, and the result is an approximation rather than an actual cost, depending on the judgment and skill of the individual accountant.

Dr. Backman shows the unsatisfactory results obtained through indirect price-fixing and also devotes a chapter to the problem of enforcement. He traces the failure of enforcement to the "uncontrollability of all the price determining forces (within a competitive system), the close interrelationship between prices and between industries . . . and the vast complexity of the economic system." The enforcement agency can at best control only the supply; without any control over demand, the latter may prove an upsetting factor and bring to nought the work of control over the supply.

In the end the author concludes that price-fixing has failed because it has been applied to only a part of trade and industry; yet in this country, we have tried an ambitious scheme called the N.R.A. with rather disastrous results, and there were few to mourn its passing. It may be urged, and Dr. Backman makes the point, that government administrators have not yet acquired "the necessary omniscience to foresee all possible ramifications of these control schemes, and . . . to devise effective safeguards . . . . " He recommends, however, that if any new schemes are adopted, at least the more apparent difficulties should be safeguarded against. With this no one can quarrel. It seems to the reviewer, however, that the obvious answer is two-fold: first, that many of these schemes are emergency measures and while a great deal of study may have gone into them, they are hurried through the legislative machinery when economic or political necessity dictates. Secondly, the more apparent difficulties probably are provided for; it is the hidden, unforseeable difficulties that cause the experiment to bog down in a welter of bureaucratic red tape. This was certainly the experience in this country during the war and the days of the N.R.A.

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[1] Chamberlin, Edward: *The Theory of Monopolistic Competition*, Harvard University Press, 1936, p. 117.

Price and Price Policies. Walton Hamilton and Associates. (New York: McGraw-Hill Book Company, 1938, pp. xiii, 565. $4.00.)

A much needed task has been begun with the publication of this book. A prologue and epilogue have been written by Professor Hamilton; between these are sandwiched a series of seven articles representing price studies in seven different fields. For the sake of the record and to give credit where credit is due, the complete series is as follows:

The Affairs Called Industry... Walton Hamilton
The Automobile—A Luxury Becomes a Necessity .... Mark Adams
The Automobile Tire—Forms of Marketing in Combat........ Albert Abrahamson
Gasoline—The Competition of Big Business .... Irene Till
Cottonseed—Joint Products and Pyramidal Control........ George Marshall
Dresses—The Impact on a Business .... Helen E. Meiklejohn
Whiskey—The Incidence of Public Tolerance in Price Policy........ Albert Abrahamson
Milk—The Politics of an Industry.... Irene Till
The Politics of Industry...... Walton Hamilton

Classical economics for a long time insisted that price was determined by cost. And while the Austrian and neo-classicists introduced demand as a factor in price determination, it was nevertheless held that at any one time, in any one market, there could be but one price for a given article. In addition, every cost accounting student is introduced to the notion that among the objects of cost accounting is the determination of costs as a means of arriving at the selling price. That none of these statements is true becomes more and more obvious from the most casual reading of the work under discussion.

Alfred Marshall rightly insisted that the interaction of demand and supply was a necessary but not the only condition in price determination; that before a price is made, all the imponderable forces present in the market must be taken into account. What these forces are is not made entirely clear, even after they are separated into long and short term factors. It is the task of Professor Hamilton's book to set forth in detail all the price determining forces to which the selected industries are exposed. When such an examination is made, it becomes apparent that the entire industry must be studied, its organization, its leaders—both personal and corporate—its marketing mechanism even its accounting structure, etc. It is from the interrelation of these factors the welter of their conflicts. that a price finally emerges. stable or unstable as the case may be. So a study of price and price policies becomes in the words of Professor Hamilton "a study in concretion."

Modern industrial policy did not spring full-fledged into existence. With the onset of the Industrial Revolution problems were created which few could foresee and with which governments were unequipped to cope. Thus *laissez faire* was able to flourish until popular reaction brought about governmental interference: the Sherman Act, the Clayton Act, the Federal Trade Commission Act, the N.R.A., the Robinson-Patman Act, and what have you. Price is no longer the master regulator of industry; it is hedged about by statutory regulation subject to inquiry by administrative boards; loopholes for evasion are eagerly sought by astute lawyers and the final determination often rests with our courts. But to justify interference with what has come to be accepted economic doctrine the government itself must have a policy; the *raison d'être* for interference is usually to be found in the break-down of competition among producers the diversification of the marketing structures and the consequent ability of some distributors to obtain more favorable terms from producers than others to the alleged detriment of the latter.

The term "competition" is of course merely the modern moral equivalent of the "law of the jungle." It is as if the nations of the world were to get together as indeed they have done to formulate rules of warfare. That these rules are made only to be broken merely reveals the shaky foundation upon which they rest. So if government undertakes to regulate industrial warfare it must make sure of its ground and proceed with caution lest the cure (read N.R.A.) be worse than the disease.

Now actually how is a price arrived at, say, in the auto industry? Is it by accumulating costs, adding a profit, and thus arriving at a selling price? Quite the contrary. "The manufacturer decides first upon the proper price, subtracts a tentative profit, and arrives at a tentative total cost" (p. 49). Thus, he is able to compute what he can afford to spend for material, labor, and overhead. He manufactures an article to a price. Indeed it has been the good fortune of the automobile industry to follow that formula and cash in on it, but only because events proved that demand was elastic and that successive lowering of prices tapped hitherto undreamed of sources of demand. In addition, it must be realized that automatic mass production has necessitated huge investments in fixed assets, which bear correspondingly heavy fixed charges, and it is the spreading of these over an ever larger production that makes possible the successive cost reductions, which in turn justify the predetermined price-cut. Are we arguing in a circle? Perhaps, but these are some of the forces, one reacting upon the other, which defy complete analysis. Thus volume, made possible by standardization, the continuous assembly line, plus vertical integration emerge as the key to costs for this industry. But beyond this, it appears that the auto manufacturers have been able to shift a considerable part of their costs during depression periods to others; unemployment for labor with the consequent lengthening of the government relief rolls, bankruptcy of parts makers, and the imposition of strict quotas upon the dealers, all have enabled the manufacturer to weather the worst of the depression.

It is obviously impossible to present in detail an analysis of each industry treated in this book. In the tire industry, the life span of a tire has been so improved that a smaller sales volume has resulted in spite of increased sales of autos. The resulting scramble of producers for the shrinking tire market helps to explain, in part, the ruinous price wars.

In gasoline, as in tires, we have a case of derived de-

mand. Here, however, the demand is not flexible. While consumers are apt to buy where gasoline is cheapest, its use does not fluctuate much within the usual price ranges. Hence, the frantic efforts of producers to build up goodwill for their respective brands, though actually there is little difference among them. The situation is aggravated by the conditions at the wells, which force producers to pump the oil out of the ground regardless of current market conditions. These facts, together with the excessive number of service stations, are the causes of the recurrent price-wars; at best, the price structure is unstable.

In cottonseed we are dealing with a joint-product industry, with all the problems involved in joint costing. Other factors to be considered are the group clashes between tenants and landlords, workers and employers, farmers and processors, cottonseed-crushers and cottonseed-oil refiners (p. 202); the activities of two trade associations in the industry operating for the benefit of special interests; and finally the pyramidal control exercised over the cottonseed industries. The price structure is of necessity one of highly interrelated prices. From the crushing mill using crude oil, cake and meal, hulls, and linters, there emerge refined oil, vegetable shortening, mixed feed for animals, etc.

In women's dresses, the picture again changes. Here we find the small manufacturer subject to the full impact of all economic changes. One year a wealthy man, the next he is struggling to make a living. The price of a dress is a peculiar compound of institutional arrangements between jobbers and contractors, of machine and handicraft production, of merchandising practices and style influences. Whiskey, on the other hand, presents problems of overexpansion, keen competition, regulation and taxation, illicit producers, etc. Finally, in the case of milk, the whole price structure has become institutionalized. As in all agricultural products, there is a lack of control over the supply. State regulation, the coöperatives, the dealer, the system of distribution, the allocation of the producers' supply to fluid milk and other purposes, these constitute the central problems of price in the industry.

To the reviewer, it seemed that Helen Meiklejohn's article on women's dresses and Irene Till's article on the milk industry constitute the best expositions in the book. On the other hand, Miss Till's article on gasoline suffers from a certain amount of repitition and even redundancy. Moreover, what emerges from a careful reading of the book is a picture of the institutional practices of each industry, rather than a clear-cut vision of pricing policies. As industry after industry is unfolded before us, we catch glimpses of the struggles, the clash of interests, the insecurity of the whole structure. Each industry is trying to solve its own problems, and each producer within the industry doubtless has problems of his own. The most important lesson to be drived is that "industrial security is as important as social security" (p. 89). Social security for the individual has been in a measure achieved through the initiative of the Federal government acting in concert with the states. Where will social security for industry come from? Certainly, industry itself must somehow be educated to the concept that the problems of industry are the problems of society, that what conduces to the benefit of society must eventually react favorably upon industry. Is the answer to be found in national planning? It is a disturbing thought; for in the background of national planning lurk the twin specters of autocracy and bureaucracy. This much only is certain; that the days of industrial *laissez faire* are numbered.

THEODORE LANG
New York University

Introduction to Accounting. Second Edition. Dallas S. Bolon. (New York: John Wiley & Sons, 1938, pp. xvi, 679. $4.00.)

This text follows the same general outline as the earlier edition. The first half of the book deals with the business affairs of a single entrepreneur. In studying this section, the students should gain a general knowledge of business practice. Such knowledge is essential because accounting is so intimately connected with all business activities that the subject cannot be fully understood and applied unless it is based on a fair knowledge of business practice. The second half develops in an exceedingly thorough manner the accounting procedure for the partnership and corporate form of organization. A considerable amount of space has been devoted to details of partnership and corporate organization, practice, and procedure. This information is essential to the proper understanding and handling of the accounts. It is pleasing to note that the author has not treated it lightly as is so often the case in texts covering such a wide scope of work. One chapter of the second section deals with manufacturing statements and accounts. Other chapters treat miscellaneous subjects such as voucher systems, valuations, inventory plans, analysis of statements, and changes of financial position.

The method of approach as given in this volume is perhaps not orthodox because it is somewhat late in the course before the student is acquainted with the entire cycle of bookkeeping procedure: journalizing, posting, taking a trial balance, preparing working papers and statements, and closing the books.

Your reviewer, however, is thoroughly in accord with the arrangement of the material as presented in this text and endorses a statement made by the author in his preface: "That a knowledge of the balance sheet and the more common transactions should precede the study of the theory of debit and credit and the mechanics of journals, accounts, etc."

Much of the text material has been rewritten and many chapters include new material covering points omitted in the first edition. The principles and procedure involved are amply supported by illustrations. Each chapter is a happy combination of text containing statement of principle and showing method of application. A noteworthy improvement over the first edition is the related question material at the end of each chapter. The same abundance of interesting laboratory and review problems is contained in the appendix.

Your reviewer congratulates the author on his accomplishment. The text is well adapted to a one-year course in accounting. It should give the elementary

student a thorough understanding of accounting principles and procedure.

PHILIP H. HENSEL

University of Western Ontario
London, Canada

Accounting in Law Practice. Second Edition. Willard J. Graham and Wilber G. Katz. (Chicago: Callaghan and Company, 1938, pp. xvii, 553. $6.50.)

That "The principal value of an understanding by the lawyer of accounting principles does not consist in an ability to keep books . . . , but rather in the added facility which it gives him in the handling of his own peculiar tasks," is a statement by the authors which will be readily agreed to by any lawyer who has a considerable practice in business affairs and will be emphatically testified to by any accountant who has been in close association with a lawyer in handling such matters. The purpose of the book, " . . . is to make available to the lawyer a succinct presentation of the principles and practices of accounting with which he is most likely to be concerned in practice." And it appears that this volume answers that requirement very well.

The thirty-two chapters of the book are gathered into six parts; the first part consisting of nine chapters dealing with the mechanics of bookkeeping, including the bookkeeping cycle, adjustments, special journals, controlling accounts and the work sheet. The presentation of this material commences with a study of the balance sheet and profit-and-loss statement and works backward to the original transactions of debit and credit and ledger accounts, and then forward again to the aforementioned statements.

Part II takes up the subject of partnerships, dealing with investments of the partners and the apportionment of profits and losses, admission and retirement of partners and dissolution and liquidation of partnerships.

Part III on corporations deals with the issuance of capital stock, incorporation of partnerships, corporate profits and losses, dividends, reduction of stock, treasury stock, dissolution, reserves, funds and related assets. In connection with the treatment of repurchased forfeited stock it would appear that such stock ought more properly to be treated differently than treasury stock, because of the legal complications that might result from the sale of such stock at an amount less than par plus forfeited payments; however, this same objection may be made to certain other accounting texts in which this distinction in handling this kind of item is not made. Another minor criticism might be made on the use of a Donated Surplus account where treasury stock has been donated and not yet resold; it would appear more advisable to designate such an item as Donated Surplus Suspense. In view of the excellent handling of the subject of corporations, however, these objections are not very material.

Part IV is devoted to Valuation and Determination of Income, discussion of current assets, investments, fixed assets, depreciation, intangible assets, liabilities, determination of income and expense, and a chapter introducing the Federal Income Tax. Also contained in this section are two chapters on public-utility valuation and depreciation, which should be of considerable interest to lawyers as a basis for further investigation in that field.

Part V on Financial Statements and Construction and Interpretation dealing with analysis of financial statements, ratio analysis, business combinations, consolidated balance sheets and profit-and-loss statements, should be particularly helpful to the lawyer who finds himself called upon for advice on financial matters in connection with loans and investment.

Part VI, Accounting for Fiduciaries, discusses accounting for decedents' estates, trusts, receivers and trustees in bankruptcy. These subjects should be of considerable value and benefit to the attorney, especially in those instances where the client relies on his (the attorney's) carrying the burden of the work in administering the trust imposed.

The second edition has been enlarged through an expansion of the treatment of stock dividends and the undistributed-profits tax, stated capital reduction to eliminate deficits, and a fuller treatment of the Federal Income Tax. The chapters on Public Utility Valuation have also been added and Part V—Analysis of Financial Statements—has been expanded.

The book contains numerous references to actual cases on points involved in the discussion and a book of problems and exercises is available which when used with the text makes possible the better use of the book for teaching purposes in a course designed for law students.

It appears regrettable that the chapter appearing in the first edition on Accounting and Office Management for Law Firms has been omitted, because of its value to the young practitioner.

The book contains many illustrative problems and their solutions, which afford a material help in understanding the discussion of the text, helping to make the presentation clear, concise, and comprehensive, without being burdensome.

HARRY M. SCHUCK

University of Wisconsin

Corporation Finance. Kenneth Field. (New York: Ronald Press Company, 1938, pp. xvi, 529. $4.00.)

A new text in the field of corporation finance presenting "the subject from the composite viewpoint of the business man, the lawyer, the investment analyst, the underwriter and the professor." This seems to include about everyone except the accountant or students of accounting!

This text, as all too many others, on corporation finance is apparently written on the assumption that the students have not studied accounting, and therefore many elementary definitions and illustrations of balance sheets and income statements are given. Some day one of our professors of finance may write a text suitable to the needs of thousands of students enrolled in schools of business where elementary economics (general principles) and one or two years of accounting are required before the student may enroll in Corporation Finance. The text material which many of these professors use

simply does not measure up to their own self-imposed prerequisites.

Corporation finance texts for students in the general college of arts are quite another matter, and it is evidently for this group that this text was written. Even here there is a duplication of definitions and illustrations that certainly must be given in a course in general principles of economics (where accounting is not a required course of the first or second year). In my judgment there is a great deal of overlapping that should be avoided.

I have no desire to point out all of the exceptions which I would take to definitions and start "a silly word battle," but it does seem unfortunate that students should be told as stated on page 11, that preferred and common stock are liabilities of a corporation and that "Surplus does not evidence a permanent commitment of funds to the business and, hence, does not constitute a part of capitalization."

I am delighted to see that he uses the term ***net working capital*** as the excess of current assets over current liabilities and that reserves are properly classified.

One paragraph each is given the subjects of The Amount of Working Capital, Inventory Turnover and Cash Budget.

In addition to the usual chapters found in corporation finance texts, the text has chapters on "segregated risk financing, the theory of issuing securities, recapitalization, direct property owning consolidations, the principles of holding company financing, and depreciation ..." materials not ordinarily found in books on corporation finance.

The chapters on strictly corporation finance topics are very interestingly written and are will illustrated. No mention is made of supplementary problem material for student use which, as an accounting instructor, I would consider desirable.

F. H. ELWELL

University of Wisconsin

The Investment Value of Good Will. Lawrence N. Bloomberg. (Baltimore: The Johns Hopkins Press, 1938, pp. xiv, 70. $.75.)

This monograph endeavors to compare the investment values of good will and tangible property. This study "was presented as a doctoral dissertation several years ago. The data and charts contained in the original have been brought up to date."

The author's problem as stated on page 12 is: "Has good will in the past earned for investors larger returns than physical assets? Or to put the question in a slightly different form: Would an investor confronted with the necessity of choosing between two stocks selling for the same price—one in a company with large physical assets and little good will, the other in a company with much good will but little in physical assets—have done better, in general, to have purchased the stock backed principally by good will or that which relied upon physical assets for earnings?"

The author made five tests, making an imaginary investment of approximately $1,000 in a certain number of "good will" stocks ("those of companies which were believed to possess a substantial quantity of buyers' attachment") and in a certain number of "physical asset" stocks.

The five tests covered varying periods of time from 1912 to 1937, and the results make "apparent an undervaluation of the good will shares. If the relative appraisals of the two classes had been more accurate, the goodwill shares would have sold at higher prices on the dates of purchase and the hypothetical investor could not have bought as many of these shares. This would have produced a closer agreement between the results. But the investing public has, in general, regarded good-will stocks as being charged with a higher degree of risk."

The monograph is decidedly interesting, and should particularly appeal to accounting instructors who are including the subject of good will in their theory courses.

F. H. ELWELL

The University of Wisconsin

Expenses and Profits of Limited Price Variety Chains in 1937. Stanley F. Teele, (Boston: Harvard Bureau of Business Research, pp. vi, 33. $1.00.)

This bulletin is a continuation of the Bureau's studies of expenses and profits of limited price variety chains. A comparison of operations in 1937 with those of 1936 reveals a slight increase in aggregate sales, a slight rise in average sales per store, a slight increase in percentage of gross margin, and an increase of total expense of more than 1 per cent. Consequently, both net profit and net gain declined with the net profit falling from 5.05 per cent in 1936 to 4.11 per cent in 1937.

The most interesting part of the bulletin is the analysis of the increase in the expense rate. The increase is accounted for almost entirely by increases in salary and wages, taxes (other than real estate, income, and sales taxes) and advertising. The increase in salaries and wages is described as follows:

> ... During 1937 the limited price variety chains, in common with other types of retail enterprises, notably department stores, were confronted with a marked increase in the efforts of labor unions to organize retail employees. While such efforts were much more strenuous in some communities than in others, one cannot but conclude that actual or potential organization of employees has become a factor which must in the future be taken into account by variety chain executives in formulating their plans and policies. Slow as the growth of unionization of retail employees may be, it seems unlikely that pay roll expenditures will decline in relation to sales until variety chain executives have devised methods whereby the productivity of the individual employee may be decidedly increased.

The increase in taxes has come from social security taxes, special state chain store taxes, and property taxes on fixtures, equipment, and inventory. These expenses may be expected to increase in the future.

It would appear to the reviewer that variety chains may expect a continuing trend of mounting expense which cannot be overcome through managerial skill. These chains are reaching a state of maturity where competition among themselves as well as with other types of retailers will tend to force expenses upward.

An indication of this fact is found in the increase in advertising expense which, although small, is significant, as a barometer of the competition in the field. The combination of an increase in expenses from taxation, labor unrest, and increased competition creates a situation in which relatively lower expenses cannot be expected. The variety chain is one of the most profitable types of retail institutions, but the present profit level cannot be maintained without a further increase in gross margin.

New to the bulletins on variety chains is an analysis of the average sales per employee hour. Among the chains, sales per employee hour varied from $1.67 to $3.45. The correlation, however, between high average sales per hour and low total expenses or high percentages of net profit was not clear cut. There was also no relationship between the average number of hours worked per week by employees and the average sales volume per hour. Although the data for these statistics are meager, there is the implication in these figures that the shorter work week in retailing causes a corresponding decrease in the weekly productivity of employees. If this is true, the shorter work week will cause relative increases in payroll expense.

A section of the bulletin is devoted to a comparison of five large identical variety chains and fourteen other identical variety chains for the period 1932–1937. The five chains, following different managerial policies than the fourteen, improved their net profit position considerably more than the latter. The success of the group of five points to a large increase in net sales per store as a method of minimizing the expense added by tax legislation. A reduction in tenancy cost has off-set, to a considerable extent, the increase in the expense of other items.

A word of caution is placed in the foreword. It is pointed out that the first nine months of 1937 were fairly prosperous while the last three included one of the sharpest business recessions in our history. The averages in the bulletin are the results of two unlike periods and perhaps not representative of either. Nevertheless, in the light of the operating results in 1938 and future years, the bulletin will be vital in bridging one of the years of transition. It is recommended to those interested in the practical operation of variety chains and to students of trends in our distributive system.

E. H. Gault

University of Michigan
School of Business Administration

The Margin Trader. Kemper Simpson. (New York: Harper & Bros., 1938, pp. xvi, 170. $2.00.)

This brief volume represents a treatment of our security markets from the standpoint of margin trading. Brief discussions are included of margin traders and their brokers, the exchanges on which the brokers operate, the banks which finance margin trading, and some of the cyclical implications of margin trading.

The general conclusion of this volume is that margin trading is of little value in itself and has harmful effects for our economy. Our exchanges, as now constituted, are regarded as market places for speculators rather than investors, and encourage excessive speculation through our well-developed system of margin trading. Moreover, the tenets of those upholding our present exchange system are founded on a philosophy of speculation. Thus, the cries of those seeking liquidity and volume are merely expressions of a philosophy which assumes the importance of a speculator's market. "Without denying that liquidity, even as apologists for speculation define it, is one desirable characteristic of an investment, it may be forcibly argued: (a) that this so-called liquidity is primarily serviceable to speculators; (b) that margin trading, like professional speculation, is concentrated for the most part in active issues, which necessary buying and selling of investors would make sufficiently liquid even if there were no speculators; (c) that the very ease with which buyers and sellers of securities can get in and out of active issues has increased the national propensity to gamble; (d) that this propensity to gamble has widened the amplitude of fluctuation in stock prices and has made for an unstable market, which is far more dangerous than a discontinuous one."

The argument, sometimes advanced, that exchanges facilitate the induction of bank credit into industry via the margin trader, is challenged. "Induction of bank credit into the securities markets via the margin trader has a different and more complex effect on industry than is generally assumed. First, as the 'new money' demanded by industry since the depression has been insignificant, and as funds for the purchase of securities have been plentiful, this apology for margin buying is no longer convincing. Second, a relatively small part of the funds received from the sale of new issues during the last decade has eventuated in the expansion of the issuing corporations' productive equipment. For over a decade Big Business has used the securities markets largely to reduce its interest charges and to remove itself from banking control. And the large issues of investment trusts and other financial companies have not resulted in any direct flow of capital into industry. Many of the funds entering the securities markets have served, first, to inflate the prices of market leaders and, second, to overstimulate the luxury-goods industries."

Both margin trading and short selling (the latter to a smaller extent) have aided in widening the amplitude of our business cycles.

Aside from some statistical materials, there is little in this volume that is new, and the attitude of personal antagonism towards exchanges and the SEC, which is evident throughout the work, leads one to question the objectivity of the study. Mr. Simpson has succeeded in stating, in elementary language, some of the problems arising out of margin trading.

Frank P. Smith

The University of Rochester
Rochester, New York

Problems in Accounting. Second Edition. W. A. Hosmer. (New York: McGraw-Hill Book Company, Inc., 1938, pp. xvii, 689. $5.00.)

This is a thorough revision of a casebook first published in 1934. In number of pages it is fifty per cent

larger and in number of cases twenty per cent. Over sixty cases from the former list have been dropped and some eighty new cases added.

The book is divided into five parts as follows: I Accounts and Financial Statements, II Bookkeeping, III Current Assets and Liabilities, IV Permanent Assets, Funded Debt, and Proprietorship, V Income and Expense. The space devoted to bookkeeping in Part II has been substantially reduced and Part IV has been more than doubled. The other parts have also been substantially increased in size.

As is normal for a casebook, no organized presentation is given of accounting technic. And the reader may wonder how students can obtain a conception of the coherence that exists, or should exist, in accounting theory from disconnected cases. But the student's use of a "workbook" may meet the first point and the second is no doubt taken care of by accompanying lectures.

Certainly the class that has thoroughly covered this book will have faced most of the issues which worry accountants and perhaps corporation executives as well. Anyone whose conception of accounting is that of advanced bookkeeping hardly deserving consideration on the university level, is likely to be amazed at the variety and complexity of the matters which the subtitles of these cases indicate are the concern of accounting. Sixteen cases, for example, are given over to inventory problems and twenty-one to plant and depreciation. Here are considered such things as excess inventory, inventory pricing, base stock, inventory reserves, and plant maintenance, plant ledger, idle plant, plant appraisals, rapid obsolescence, depreciation and working capital, retirement accounting.

Not the least important, especially for the graduate student of business, are the extensive excerpts from the reports of leading industrial companies. The student can hardly escape the conviction that management exercises a most important function in reporting clearly and in detail upon its activities. And regardless of what the critic may think of the wisdom of specific managerial decisions, the best reports make the decision a matter of record and usually accompany it with the reasoning behind the action.

The student will also come to realize that good accounting and clear accounting reports are vital to successful business operations. He will learn that accounting, if it is worthy of the name, will be a dependable mirror of managerial policies, and he will come to know the spots in which to seek evidence that a given management is lacking in candor or a keen sense of stewardship.

This is as it should be in a book that is focused upon the study of business policies. The study of accounting is one of the avenues for the study of policy. There are others, but accounting is one of the most direct approaches. The student may feel, after he has also studied the problems of corporation finance, that his accounting included many matters of concern in that other field. But sooner or later he will realize that management dare not conceive of the departments of the enterprise as watertight compartments. Management is largely a matter of effective coördination, and how can one better perceive that coördination is a central theme than by seeing college subject matter integrated?

It is one of the teacher's principal problems to see that his students recognize integration as such and do not dismiss it as useless duplication and wasteful overlapping.

Another of the teacher's burdens, and one strongly emphasized in the use of the case method, is to see that students learn to discriminate good policy from bad, good reporting from poor reporting. Such a text as this may leave the impression that all of the treatments given are equally acceptable. But this would not be a fair criticism unless one were convinced that the case-book teacher would not supply the deficiency. His task is largely one of drawing principles out of situations. The teacher who uses a text of principles must supplement principles with situations. It comes down to this: the qualified teacher will get his subject over whatever the materials at hand. A good book of principles will help; so too will a good book of cases, like the one under review.

A. C. Littleton

University of Illinois

Essentials of Accounting. W. A. Paton. (New York: Macmillan Company, 1938, pp. xxi, 830. $5.00.)

When one reads several beginning books on Accounting he is impressed with the large number of rather satisfactory texts that are in use today. Some of them are present day editions of older books and others are of fairly recent origin. They present the subject of Accounting to first-year students in different ways, but generally they do a good job of it. Sometimes they make contributions to accounting theory, but more likely they give only a new method of approach or a new means of presentation. At any rate it is pleasing to find how many good books, from a teacher's point of view, are available today.

The book under review is not just another of these books, high as the standards of these other books may be, nor is it just another edition of one formerly published. True enough it supersedes another book with a slightly different title, and true enough the basic ideas have been in print for more than 20 years, but, nevertheless, it is a new book and one which represents the accumulated ideas and experiences of one of the master minds of accounting. No one, no matter how many years he has taught, or no matter how many years he has practiced, can read this book without interest and without profit. Although a beginning text book, it is intensive and thorough. The intention is to teach the student to think, to make him put forth the same intellectual effort that he would in any liberal arts course, and it is intended to raise the level of accounting teaching above that which until recent times was altogether too typical of our accounting education.

It is, of course, impossible to do more than point out some of the salient characteristics of the book but some of these points should be looked into. The book really deals with accounting principles. It accepts the business enterprise as the economic organization of the accountant and it even, perhaps with reservations, accepts the

point of view of the proprietors as the persons for whom the books and records are primarily kept, even though it is recognized that there are outside parties who are also interested. This is indeed a concession which has been made and which is definitely an improvement over the dogmatic comment once made that the literature of accounting is altogether too much saturated with the proprietorship concept.

The statement method of approach is followed with the philosophy of debit and credit worked out clearly and logically through equations and numerous examples. A marked improvement in the book is to be found in the introduction of many solutions to problems which are used to fix in mind the principles that have always fully been considered. Few books indeed have approached this nice balance between principles and applications.

The corporate form of organization has been accepted generally as the most desirable form to use as the basis of discussion, and the manufacturing corporation has been introduced early. The concept of net revenue remains essentially the same, as does the concept of income. Except in railroad and public-utility accounting the author's terminology does not in all instances coincide with industrial accounting. Since the terms used, however, have merit this should not be taken as an objection. It is only necessary to acquaint the student with this variation.

The subject matter in general is comprehensive and covers all the material needed in a beginning course. Where the course covers numerous sets and problems it is sufficient work for 3 semesters. The reviewer has not seen the volume of Problems and Practice Sets by Paton, Briggs and Laing which accompanies the text and cannot, therefore, indicate how many semester hours the whole course might well cover.

The textbook must be regarded in a favorable light. Its originality, its clearness, its piercing of hard and controversial topics, its comprehensive treatment of the subject, its keen statement of principles, its thorough descriptions and its numerous typical illustrations, mark it as a monumental work, and a work which distinctly represents a valuable contribution to accounting literature.

W. S. KREBS

Washington University, St. Louis

Monetary Policies of the United States, 1932–1938. James D. Paris. (New York: Columbia University Press, 1938, pp. viii, 198. $2.75.)

This study is concerned with our monetary bases (gold, silver) and with the leading types of circulating media of exchange. A brief sketch is included of the economic conditions prevailing immediately preceding the inauguration of the present Administration, in 1933, and the various legislative acts concerning gold, silver, national bank notes, and Federal Reserve Currency are studied. This book does not deal, except incidentally with such topics as commercial bank credit or Federal Reserve credit.

Chapter II deals with the manipulation of the price of gold and the devaluation of the gold dollar. The analysis proceeds from the situation resulting from the suspension of the gold standard, by England, to the events leading to the bank holiday in this country, then to the suspension of the gold standard here. The legislation that followed the suspension of the gold standard, and the manipulations of gold prices, are treated in detail, with the various policies which have been followed at different times contrasted as to aim and effect. "... the gold policy of the United States consisted of a series of measures which 'nationalized' gold, raised its price, fostered an increase in its production, and reburied it." "... At the end of 1937 the gold policy of the Administration was still in a state of flux. Persistent rumors as to further devaluation, and apparently substantial Congressional support for it, give rise to more fears. We are still left with the question: How much further is the Administration going in its groping about for an economically sound gold policy?"

Chapter III deals with the silver policies of the Administration. Again, the legislative acts have been analyzed. The international agreements arising out of the London Economic Conference, which formed some sort of a base for the actions of the Treasury, are outlined as to content and possible effects. And again, the conclusions are not flattering to the efforts of the present Administration to "do something" for silver. "Of the goals which it was sought to achieve through the Silver Purchase Act and through complementary policies of the Government, none has been reached except the increase in price to the domestic producer. But the international negotiations which had to be gone through the loss of international prestige and goodwill, and the financial chaos perpetrated upon some of the foreign nations are too high a price to pay for such a subsidy to so small a group."

The remaining chapters deal with the developments regarding Federal Reserve notes and bank notes, and national bank notes. It is admitted, in this discussion, that some of the Acts recently passed have aided in simplifying our currency system. This has been especially true with respect to the national and Federal Reserve bank notes. The changes in the backing permitted for Federal Reserve notes, however, are opposed on the ground of lack of elasticity in the new type of note. "It is deplorable, though, that a currency which was created to fluctuate with the ebbs and flows of business, as reflected in bills, acceptances, and other available eligible paper, has now potentially become but another national bank note which can be backed to a large extent ... by Government obligations instead."

With but few exceptions, the conclusions arrived at in this work are unfavorable to the type of financial policies that have been followed in the past seven years. The conclusions are supported by an excellent array of statistical materials and include much material that is difficult to secure. This, together with the excerpts from statutes which are included, makes the study an excellent reference work for current data on gold, silver, and our paper currencies. In a few instances the conclusions presented seem to be based to a large extent on merely minor happenings or deviations from policies which are not of great significance. In other places the comments are perhaps more critical than the evidence justifies. On

the whole, however, the material presented does justify the conclusions reached.

FRANK P. SMITH

University of Rochester

Elementary Accounting. George H. Newlove, Leo C. Haynes, and John A. White. (Boston: D. C. Heath and Company, 1938, pp. xi, 684. $4.00.)

This text provides sufficient material for one year of class-room work. It contains ample illustrations of accounting techniques, forms, and other business records which increase its usefulness to the students. Its scope is broader than that of most elementary texts in accounting and, as one might expect therefore, the intensity of treatment of some subjects is less than might be desired. For example, little attention is given to problems involved in the determination of income. It is apparent from the preface, however, that the authors purposely broadened the scope of the book since it was designed for students coming chiefly from nonurban communities who were probably unfamiliar with business organization and techniques.

The presentation of individual chapters is straightforward, and students should have little difficulty in absorbing the subject matter provided they do a reasonable amount of work. The order of presentation of the various subjects, however, will be questioned by some authorities. This is particularly true of Unit II, where there appears to be little logic behind the sequence of chapters. But this criticism may be unimportant since the text has been used in practically its present form in the University of Texas for several years.

C. L. BURRILL

Harvard University
Graduate School of Business Administration

Twenty years ago there was an undoubted dearth of accounting texts. The intervening years have seen a steady enrichment of accounting literature in all its branches. The present text is the latest addition to a distinguished line of texts now available for study or reference on the part of students preparing for a business career or for a professional career as accountants. The book contains nothing new of course, but that is not expected since the content of a first-year course has become fairly well standardized. The merit of the book lies in the manner of its presentation. To begin with, using the now familiar balance-sheet and equation approach, the authors have presented a complete accounting cycle without the introduction of any merchandising activities. This is accomplished by using a service business as an illustration, in this case that of a professional accountant. It is to be hoped that the accounting students are duly impressed when they see the profit and loss statement of Tom Potter, the professional accountant, at the end of the first month's transactions. They forget of course that Potter started with one thousand dollars capital, and that the thousand dollars like the first million are the hardest! Nevertheless, the omission of the merchandising transactions enormously simplifies the student's approach to debits and credits and his understanding of the closing process. Incidentally, the authors are sticklers for the technical minutiae of bookkeeping and have carefully explained all the accepted conventions of the bookkeeper's art, a matter often neglected by other writers. With one of these conventions this reviewer, however, must disagree—namely, the technique of ruling off with a single line those items in a customer's or creditor's account pertaining to the same invoice, particularly where partial payments are made (see pp. 96–97). The scheme works well enough when payments received from a customer, for example, are applied against the oldest open invoice. It does not work where part of an invoice is in dispute and payments are made on subsequent invoices, the older item in the meantime being left partly unpaid, pending settlement of the dispute. Also where periodic payments are made on running accounts without reference to specific invoices, the scheme must also break down. Other devices are available that seem to work better.

The authors without wasted effort carefully explain merchandising activities and the record underlying them, again completing the cycle with necessary adjustments for inventories. It is to be wished, however, that all adjustments except for the closing inventories had been deferred to chapter 7, where such adjustments are fully covered, and excellent summaries prepared for the guidance of the student. Particularly welcome are the illustrations for alternative adjustments of mixed accounts (pp. 134–137).

In the same competent manner in which the authors treated the introductory matter, they then present chapters on financial statements, special journals and controlling accounts. The chapter on locating and preventing errors comes rather late, while the one on financial statements could be brightened up by additional illustrations, particularly through the presentation of balance sheets of well-known companies, of which many are available. There follow chapters on negotiable instruments, interest and discount, and the voucher system. These bring to an end Part I of the book. The use of the discount column in the cash books could have been introduced somewhat earlier.

Part II opens with an introduction to partnership accounting, which takes us through the usual steps of organization, operation, admission of partners, distribution of profits, and dissolution. The case of liquidation by instalments is omitted.

Particular commendation must go to the authors for their lucid treatment of corporate surplus; but other topics, such as reserves, treasury stock, and no-par stock have received but scanty treatment. Nor has the exact relationship between reserves and funds been as clearly brought out as might be desired, in view of the popular misconceptions on the nature of reserves.

The chapter on sales and consignments as well as chapter 27 on cost accounting controls and chapter 29 on branch accounting might well be omitted from a first year text; but doubtless their inclusion may be explained by local conditions. Chapter 23 and 24 on valuation of current and fixed assets while satisfactory could stand more expanded treatment. Chapter 28 on interlocking ledgers is welcome. Chapter 30 on statement

analysis contains in addition to ratio analysis a brief treatment of comparative balance sheets and profit-and-loss statements. But it does not cover the statement of resources and their application.

The last chapter on mechanical aids to accounting and simple system installation is of necessity brief. The only illustrations in the chapter are two rather poorly reproduced Hollerith cards, but the accompanying text is clear and simple. Some pictures might help, but space limitations undoubtedly prevented more extended treatment of this very fertile field.

Everything presented in this text shows very careful workmanship and thorough grasp of the subject by the authors. Accounting has come of age; its literature clearly evidences the fact. The authors deserve our congratulations and thanks.

THEODORE LANG

New York University

UNIVERSITY NOTES

University of Alabama

Mr. W. Howard Mann has resigned as instructor, and Messrs. Bruce Futhey and J. M. Charlton, Jr., have been appointed as instructors.

The Alabama Society of C.P.A.'s will hold its annual meeting at the university next spring. Professor C. H. Knight was elected secretary.

University of California at Los Angeles

Mr. Elston K. Herrold has been appointed associate in accounting. Dr. Wilbert E. Karrenbrock is heading a departmental committee that is considering the feasibility of offering graduate study in accounting.

A revised edition of *Business Statistics*, by professors Ira N. Frisbee and John R. Riggleman, will soon go to press. The enrollment in federal tax accounting, a course given by Professor Frisbee, has doubled over last year.

University of Denver

A new course in retail accounting is being offered, with Mr. Vincent Lorimer, department store executive, in charge.

A department of government management has just been established under a grant of $29,000,00 by the Alfred P. Sloan Foundation. A maximum of ten students, including holders of fellowships, are admitted to the two-year course of graduate study. The degree awarded at the end of the program of study is "Master of Science in Government Management." The basis of the work is accounting. Students following the two-year program are expected to engage, part of the time, in field work such as auditing local units of government in the Denver region.

Harvard University, Graduate School of Business Administration

Mr. C. L. Burrill has been appointed to the staff as assistant professor of accounting. Professor A. W. Hanson is teaching a new course in accounting problems. A new edition of the School's problem book in accounting by professor W. A. Hosmer, was published this fall. Mr. T. H. Carroll of the accounting staff recently completed the requirements for the D.C.S. degree.

University of Illinois

Important changes have occurred in the curriculum this year. Undergraduate accountancy students are required to take a course in speech in the sophomore year and a course in report writing in the senior year. The degree of master of business administration is being offered for the first time to commerce students who complete a fifth year of study in commerce and economics subjects. The fifth year's study covers managerial aspects of business, and includes a correlation of production, marketing, accounting, finance and other theoretical and applied economic aspects of business.

The accountancy club continues, with a membership of 400, as the most active student academic organization on the campus.

Indiana University

Mr. W. F. Suttles has been added to the staff as acting instructor in accounting. Work was begun in November on the construction of a new building for the School of Business.

University of Iowa

Leaving the department is J. M. Cadwallader, who enters into public accounting practice in Denver. Arriving as a staff member is H. W. Wright. Professor S. G. Winter was recently elected a trustee of the Iowa Society of C.P.A.'s. Professor Winter read a paper on municipal accounting at the society's annual meeting in Des Moines on October 7.

Montana State University

Dean Line addressed a recent meeting of the Montana State Accountants Society on the subject, "Accounting as a Profession." Dean Clem Collins of the University of Denver also spoke at this meeting. Another tax conference is being planned under the joint sponsorship of the accountants society and the university.

University of Nebraska

Mr. Raymond Dein has left for the University of Minnesota to continue work for the doctorate. A. G. Wilson and A. B. Carson have been added to the teaching staff as part time instructors in accounting.

College of the City of New York

Messrs. H. L. Kuntzleman and S. B. Tunick, of the staff, were awarded the doctor's degree by New York University last June.

A book entitled *Advanced Accounting*, volume 1, was completed by the authors, E. I. Fjeld and L. W. Sherritt. A second volume by the same authors is in preparation.

The accounting society of the School of

Business has started to publish *The Accounting Forum*, which has a present circulation of 3,500.

Professor George M. Brett was elected by members of the accounting department for a three-year term as chairman. A new ruling now in effect in the city's municipal colleges requires that departmental chairmen shall be elected by department members for a three-year period.

Northwestern University

Professor David Himmelblau spoke on "Auditors' Certificates" at two recent meetings: (1) American Institute of Accountants, Cincinnati, September 28, and (2) Illinois Society of Certified Public Accountants, Chicago, November 17. Professor Himmelblau spoke on "Control of Inventories" at a meeting of the Chicago chapter of the N.A.C.A. on September 15.

Mr. J. L. Penny of the evening teaching staff was elected secretary-treasurer of the Illinois Society of C.P.A.'s.

University of Oklahoma

Professor A. W. Johnson was recently made a member of the American Institute of Accountants.

Ohio University

A student accounting organization, Beta Psi fraternity, has been started with a membership of 40. The fraternity publishes a quarterly called *Beta Psi Journal*, and meets twice each month during the school year. On November 14 last, the fraternity was a guest of professor L. J. Otis at a meeting of the N.A.C.A. chapter in Columbus, Ohio. During this meeting Professor Roy B. Kester of Columbia University spoke on "Accounting Principles as Aids to Junior Members."

The work in auditing has now been expanded into a full year of study, carrying seven semester hours of credit and including the use of practice sets.

University of Oregon

Professor C. L. Kelly has prepared a volume of C.P.A. problems, which he uses in his year course on the subject.

University of Pennsylvania

Dr. William H. Taylor, formerly assistant professor of accounting at Marshall College, Huntingdon, West Virginia, has been appointed instructor in accounting. Mr. Calvin H. Hankin has been appointed assistant professor of accounting. Mr. Hankin was associated for the last six years with a law firm in Philadelphia.

Mr. Harry Ness, who teaches in the extension division, was elected president of the Pennsylvania Institute of C.P.A.'s. Mr. C. W. McDowell who teaches in the evening school, was elected chairman of the Philadelphia Chapter of the Pennsylvania Institute of C.P.A.'s.

University of Southern California

The following research projects are now in progress: R. J. Burby, "Analysis of Capital Stock Valuation in Close Corporations"; Rex Ragan, "Tax Avoidance through Life-Insurance Trusts"; H. D. Campbell, "The Simplification of Actuarial Formulae"; F. W. Woodbridge: (1) "The Relation between the Reserve for Doubtful Accounts and Actual Losses," (2) "Capital Stock—Present Laws and Regulations, Presentation and Interpretation on the Balance Sheet," (3) "Anticipated Realization of Current Assets in Relation to Agreed Liquidation Dates of Current Liabilities."

The following publications have recently appeared in the *Southern California Business Review:* Rex Ragan, "Your Estate and Mine"; F. W. Woodbridge, "An Analysis of Debt-Paying Ability." Professor Woodbridge also wrote an article on "Reserves," which was published in the August, 1938, issue of the *Journal of Accountancy.*

University of Tennessee

Arriving as instructor in accounting and economics is Mr. Marlyn Smull from the University of Virginia.

An *Accounting Manual for Counties of Tennessee*, by Professor W. H. Read, was published recently by the extension division of the University. Professor Read was re-elected treasurer of the Tennessee Society of C.P.A.'s.

A course in governmental accounting is being offered for the first time.

University of Texas

Mr. Ellis M. Jowell, of the Stephen F. Austin State Teachers College, is visiting instructor this year. Mr. F. F. Tannery has been promoted to assistant professor of business administration. Mr. Tannery has returned from his position as first assistant state auditor.

Tulane University

Dr. Paul C. Taylor has been appointed as professor of accounting. Dr. Taylor is a certified public accountant with teaching records at the University of Illinois and University of Kentucky. During the past five years he was head of the cost and planning departments of the Nineteen Hundred Corporation.

NEW BOOKS

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AMERICAN ACCOUNTING ASSOCIATION

23d Annual Meeting
Detroit-Leland Hotel, Detroit, Michigan
December 28-30, 1938

First Session—2:00 P.M., December 28, Alpine Room, Detroit-Leland

CHAIRMAN: E. A. Heilman, President

TOPIC: Accounting Theory and Practice

PAPERS:

"Some Current Problems in Accounting," William W. Werntz, Chief Accountant, Securities and Exchange Commission

"Eliminating Ratios and Using Time as a Direct Factor In Determining Debt-Paying Capacity," Fred W. Woodbridge, University of Southern California

"Depreciation and the Courts," Perry Mason, University of California

Second Session—8:00 P.M., Alpine Room, Detroit-Leland

CHAIRMAN: George R. Husband, Wayne University

TOPIC: Discussion session, no organized program

Third Session—9:30 A.M., December 29, Alpine Room, Detroit-Leland

CHAIRMAN: Fayette H. Elwell, University of Wisconsin

TOPIC: Governmental Accounting

PAPERS:

"The Present and Future of Governmental Accounting," Carl H. Chatters, Municipal Finance Officers Association

"The Application of Governmental Accounting Principles to Practice," Ira R. Frisbee, University of California at Los Angeles

"Governmental and Institutional Cost Accounting," Gustave A. Moe, Public Administration Service

"Practical Problems in Governmental Accounting," George D. Bailey, Ernst & Ernst, Detroit, Michigan

12:00 Luncheon of Grand Chapter of Beta Alpha Psi—Silver Room, Detroit-Leland (Grand Council and Permanent Vice-Presidents of Chapters)

Fourth Session—2:00 P.M., December 29

Round Tables on Teaching Problems

TOPIC A: Round Table on the Teaching of Elementary Accounting—Alpine Room, Detroit-Leland

CHAIRMAN: Harvey G. Meyer, University of Tennessee

SPEAKERS

"Accounting Courses for Students of Law," Willard J. Graham, University of Chicago

"The Accounting Course in the Junior College," William H. Conley, Wright Junior College, Chicago

And other speakers

General Discussion

TOPIC B: Round Table on the Teaching of Auditing—Detroit-Leland

CHAIRMAN: W. D. Wall, The Ohio State University

SPEAKERS: "The Content of the Course in Auditing," Paul E. Bacas, New York University

"The Auditing Laboratory," T. W. Byrnes, Columbia University

"Is There a Theory Basis for Audit Procedure?" Edward J. Kirkham, University of Illinois

And other speakers

General Discussion

Fifth Session—6:30 P.M., Alpine Room, Detroit-Leland

Annual Banquet and Business Meeting

Reports of Officers and Committees

Sixth Session—9:30 A.M., December 30, Statler Hotel

(Joint Session with the American Marketing Association)

CHAIRMAN: Howard C. Greer, Institute of American Meat-Packers

TOPIC: Cost and Marketing Problems Arising Under Fair Trade Laws

PAPERS:

"Economic Significance of Fair Trade Laws," C. E. Griffin, University of Michigan

"Marketing Costs as Evidence in Connection with State Price Laws," Herbert F. Taggart, University of Michigan

"Quantity Discount Schemes under the Robinson-Patman Act," Harry J. Ostlund, University of Minnesota

"Cost Accounting as Evidence before the Federal Trade Commission," Albert E. Sawyer, The Dennison Company

General Discussion

12:30 P.M., December 30—Luncheon with the Michigan Society of Certified Public Accountants at the Detroit-Leland Hotel

Seventh Session—2:00 P.M., December 30, Colonial Room, Detroit-Leland

CHAIRMAN: W. A. Paton, University of Michigan

TOPIC: Accounting Principles

PAPERS:

"Legal and Accounting Concepts of Capital and Surplus," James L. Dohr, Columbia University

"Capital Gains and Losses and Income Taxation," John J. Reighard, University of Minnesota

"Revision of the Tentative Statement of Accounting Principles," A. C. Littleton, University of Illinois

General Discussion